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THE GLOBAL FINANCIAL ARCHITECTURE

Lawrence H. Summers	Building an International Financial Architecture for the 21st Century
William A. Niskanen	Reshaping the Global Financial Architecture: Is There a Role for the IMF?
Steve H. Hanke	Reflections on Exchange Rate Regimes
Laurence H. Meyer	Increasing Global Financial Integrity: The Roles of Market Discipline, Regulation, and Supervision
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INTRODUCTION

MONEY IN THE NEW MILLENNIUM: THE GLOBAL FINANCIAL ARCHITECTURE

James A. Dorn

> The key to avoiding [international currency] crises is not international gimmickry. Instead of fiddling with exchange-rate arrangements, policymakers should pay attention to the currencies themselves. So far, absurdly, these remain undefined in value; and their values depend precariously on the changeable policies of central banks, which are constantly badgered with short-run-oriented advice from home and abroad.
>
> —Leland B. Yeager (1998: 264)

Fundamental Monetary Reform

The Mexican currency crisis of 1994–95, and the ensuing crises in Asia, Russia, and most recently Brazil, have focused attention on the global financial architecture and provided an opportunity to think about fundamental monetary reform. Policymakers are beginning to acknowledge that the system of pegged exchange rates is not feasible in a world of mobile private capital, and that a clear choice must be made between rigidly fixed exchange rates and freely floating rates. But most policymakers continue to ignore the deeper issue of the inherent weakness of monetary regimes based on discretionary government fiat monies.

The basic issue is, Will governments leave markets alone and focus on establishing a legal framework for free trade, free capital flows, and sound money, or will they be led by the so-called best and brightest to create institutions that enhance the discretion and power of the state? The temptation is to think that we can improve upon the spontaneous or undesigned order of the free market by deliberately

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designing a new global financial architecture. The problem is that, when government planners and bureaucrats are doing the designing, the incentive is to have too much government discretion and too little market discipline.

Thus, the debate over a new global financial architecture is, at heart, a debate over the role of government in a free society. The overriding principle of freedom should not be compromised by limiting the choice of monetary institutions to a little more or a little less government discretion. Rather, the choice should be between government fiat money systems, on the one hand, and free-market monetary systems, on the other.

Much has been written about the International Monetary Fund bailouts and the problem of moral hazard, but one should not forget that the moral hazard problem is only one aspect of the difficulties facing the current international financial system. Pegged exchange rates and discretionary government fiat monies are the underlying sources of instability in the global monetary order. With either rigidly fixed or freely floating exchange rates and a rules-based monetary system, there would be no serious adjustment problem for the balance of payments and, hence, no major problems of liquidity or confidence. With a money of stable value and with prices set in the free market, adjustments would take place more smoothly—and errors would be corrected more quickly—than under the current hybrid system. In such a world, of course, there would be no role for the IMF.

The failure of central planning means that the relevant choice for the new millennium is between market liberalism—a system in which individual liberty predominates—and market socialism (the so-called mixed economy or Third Way), in which the state plans the market and compromises freedom and responsibility. The setbacks in those countries practicing "crony capitalism," however, should make the consequences of the choice between true and false markets clear. It has not been an excess of capitalism and freedom that is at the heart of the global currency crises in developing nations but, rather, an excess of government and interventionism.

These broader philosophical issues should not be lost sight of in the debate over the specifics of a new global financial architecture.

The Global Financial Architecture

Most of the papers in this issue of the *Cato Journal* were first presented at the Cato Institute's 16th Annual Monetary Conference,

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October 22, 1998, which was cosponsored with *The Economist*.[1] The papers have been revised and updated for publication.

That conference—"Money in the New Millennium: The Global Financial Architecture"—was a reaction to U.S. Treasury Secretary Robert Rubin's call for a new "global financial architecture" that is "as modern as the markets." His plan calls for increasing transparency and disclosure, strengthening the role of the IMF and other multinational financial institutions, making the private sector more accountable, and improving financial regulation in emerging market economies (Rubin 1998). The idea of the conference was to consider the institutional changes needed to make the global financial system less disturbance prone and, thus, to examine the role of market forces in shaping the new financial architecture versus the role of government.

If the fundamental solution to a country's inability to meet its obligations to foreign creditors is a workout negotiated by the debtors and creditors, why are disbursements from official sources needed? Has the IMF become "the Typhoid Mary of emerging markets, spreading recessions in country after country," as Jeffrey Sachs contends? The distinguished contributors to this volume address those questions and others relating to the shape of monetary institutions and the regulatory framework in the 21st century and beyond, including the implications of European monetary union for the global financial architecture, the role of dollarization, and the use of capital controls to stem hot money. In considering those and other topics, lessons are drawn from the Asian financial crisis and from other historical episodes of monetary instability.

An Overview

In his opening paper, *Lawrence H. Summers*, deputy secretary of the Treasury, considers one essential element of building a new global financial architecture—namely, how to ensure that capital flows efficiently from developed to developing countries. He wants "a safe and sustainable system" as opposed to the uncertain and volatile system of today. Three ideas stand out in his analysis:

- "Market discipline is the best means the world has found to ensure that capital is well used."

[1]The paper by Steve Hanke and Kurt Schuler was added after the conference, as was the paper by Juan Luis Moreno-Villalaz. Clive Crook, deputy editor of *The Economist*, contributed greatly to the success of the conference.

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- "As capital market integration increases, countries will be forced increasingly to more pure floating or more purely fixed regimes."
- "The most important determinant of every country's fortunes is the policy choices of its people and its government."

Summers reminds us that we cannot have all good things; choices must be made—"The core proposition of monetary economics is a trilemma: that capital mobility, an independent monetary policy, and the maintenance of a fixed exchange-rate objective are mutually incompatible." That is why, if countries want to benefit from free international capital markets, they must choose either freely floating exchange rates or permanently fixed rates.[2]

In a world dominated by private capital flows, the days of pegged exchanges rates are numbered. Indeed, Treasury Secretary Rubin has recommended that emerging economies adopt credible institutions that either rigidly fix the exchange rate (e.g., by adopting a currency board) or let the exchange rate float. He now believes that intervening to defend unsustainable pegged rates is a mistake. According to Rubin (1999), the general rule should be: "The international community should not provide exceptional large scale official finance to countries intervening heavily to defend an exchange rate peg."

If that rule were followed rigidly, and pegged exchange rates lost their appeal, the IMF's role would be greatly reduced—and that is exactly what *William Niskanen*, Cato's chairman, thinks should happen. Rather than searching for new roles for the IMF, he would abolish it. In his paper, he argues that the global financial architecture in the 21st century would be more secure without an agency that, instead of producing healthy economies, has created "loan addicts."

Steve Hanke, professor of applied economics at the Johns Hopkins University, has long criticized pegged exchange rates as a pseudo system based on political compromise rather than free-market principles. For him, both freely floating rates and permanently fixed rates are consistent with market liberalism. The poor record of central banks in developing countries leads Hanke to argue for a currency board system as a credible way to bring about monetary stability in emerging economies. In his paper, he emphasizes the danger of exchange controls, which he sees as "nothing more than a ring fence within which governments can expropriate their subjects' property."

[2]This trilemma is well known in international monetary economics, but has often been lost sight of in practical policy proposals. The pegged exchange rate system is a prime example. For an insightful discussion of the so-called doctrine of alternative stability, see Yeager (1976: 651–54) and Friedman (1998).

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Hot money and one-way option speculation are related to pegged exchange rates, argues Hanke. Imposing capital controls is not the answer to capital flight. They will only erode freedom and decrease wealth in those nations that limit convertibility and constrain capital flows. When people are free to move their capital to higher valued uses, governments must change their policies or suffer the consequences.

Dollarization is a tighter form of currency unification than a currency board, and can quickly give people in developing countries a secure medium of exchange. That is why, even without official dollarization, many people in emerging economies choose to hold U.S. dollars rather than an unstable home currency. Hanke recommends dollarization as a sound monetary institution for those countries that do not have the monetary and fiscal discipline needed to maintain the long-run value of their currencies.

Hanke and *Kurt Schuler*, an economist with the Joint Economic Committee, propose that Argentina move from a less than perfect currency board system to dollarization. They think that Argentina should do this unilaterally, so that it is not bound by an official treaty, and that people be given the choice of moving to another currency if the Federal Reserve changes the course of monetary policy. They argue that the transition to dollarization would be relatively easy and that Argentina's new monetary constitution would lead to lower interest rates and faster economic growth than under the existing currency board system. Argentina could certainly learn from Panama's experience with dollarization, which, as *Juan Luis Moreno-Villalaz* notes in his paper, has been positive.

Laurence H. Meyer, a member of the Board of Governors of the Federal Reserve System, discusses the roles of market discipline, regulation, and supervision in increasing global financial integrity. He makes a case for greater disclosure to improve market discipline and calls for reform of international capital standards and bank supervision. Reforms should take account of the dynamics of global capital markets and recognize different approaches to risk management. The Basle capital standards should reinforce market discipline, if global financial integrity is to be improved.

Randall Kroszner, an economist at the University of Chicago's Graduate School of Business, shows how private regulation has evolved to create stability in global financial markets. Participants in newly developing financial markets have an incentive to create institutions that benefit all traders by reducing risk and increasing stability. Clearinghouses, rating agencies, contractual innovations, organizational changes, and so on have all worked toward those ends. If continued progress is to be made in the search for global financial order, Kroszner

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advises that "public regulation should not be permitted to crowd out dynamic private regulation."

The bailouts of the 1990s differ substantially from earlier rescues. Under the Bretton Woods system, countries that faced temporary balance-of-payments problems could get official assistance to maintain a pegged exchange rate. Today, the assistance is of longer duration, much larger, and frequently aimed at countries that have already abandoned a pegged rate. Banks and investors who are bailed out are the primary beneficiaries. Moreover, those countries typically face insolvency rather than mere liquidity problems. *Michael D. Bordo*, an economic historian at Rutgers University, examines those differences and finds that the large bailouts of the 1990s, beginning with Mexico, have created a serious moral hazard problem. If lenders and borrowers expect to be bailed out, they will have an incentive to engage in more risky ventures and lend and borrow excessive amounts. He exposes the myth of pure contagion, and argues that history shows that those economies with sound policies are not much harmed by a currency crisis in an economy with unsound policies.[3] Yet, the threat of contagion has been used to justify the very bailouts that increase moral hazard and make future bailouts even likelier.

Bordo concludes that "a pervasive problem in the case of all crises was pegged exchange rates." Such rates create a false sense of confidence and encourage home-country banks to borrow short term, at low interest rates, in dollars, and to relend long term, at higher interest rates in the local currency—with the expectation that there will be no devaluation. However, once speculators recognize that the home currency is overvalued, they will drain foreign exchange reserves and the peg will collapse. The damaging effects of that compromised system could be avoided, says Bordo, by allowing exchange rates to float freely. The global financial architecture would also be improved, according to Bordo, by changing lending practices: "Today's monetary authorities, including the IMF, should follow Bagehot's principles: Lend short term at a penalty rate on good collateral that exceeds the value of the loan."

Harvard economist *Jeffrey Sachs*, another critic of pegged exchange rates and the IMF, contends: "It is not the devaluation but rather the *defense* of the exchange rate preceding the crisis that has often opened the door to financial panic." The devaluation merely signals the loss of foreign exchange reserves at the central bank. Foreign creditors panic because they know the bank cannot act as a lender

[3]For an excellent discussion of "the myth of contagion," see Anna J. Schwartz (1998: 252–54).

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of last resort for dollar-denominated debts, so they attempt to take their capital out of the country as quickly as possible. In the process, the domestic economy shrinks. The normal sequence begins with net capital inflows to developing economies having pegged exchange rates, the exchange rate becomes overvalued, reserves are depleted, a devaluation occurs, and there is a net capital outflow. In Sachs's view, "IMF actions have probably contributed to the [creditor] panics."

Like Bordo, Sachs believes that it would be much better to let currencies float than to peg them at unrealistic rates.[4] There would then be no need to hold large foreign reserves with which to defend an overvalued currency. In addition, Sachs would limit short-term borrowing in emerging economies by the use of "prudential standards" (rather than capital controls), improve capital adequacy standards, and allow greater foreign competition and ownership in the financial sector. He also suggests that new mechanisms should be developed that allow creditors to respond to panics collectively, including "methods for creditor-debtor bargains for stretching out loans, converting debts to equity, and writing down claims, in the event that a panic is followed by a solvency crisis." Those reforms would reduce moral hazard by moving decisions to the market and private parties and away from governments, central banks, and international organizations.

Y. C. Richard Wong, executive director of the Hong Kong Centre for Economic Research, draws some important lessons from the Asian financial crisis. He attributes that crisis to multiple factors, including overconfidence in pegged exchange rates, excessive capital inflows (based, in part, on the expectation of a bailout as in the 1994–95 Mexican crisis), currency and maturity mismatches, poor risk assessment practices by bankers, and crony capitalism. The two most relevant lessons from the Asian crisis are that (1) pegged exchange rates are bound to fail in today's global economy and (2) such rates inevitably lead to a moral hazard problem, given the existence of the IMF.

If Asian central banks cannot be trusted (the Thai central bank deceived markets by overstating foreign exchange reserves, which led to capital flight once the truth was known), then a currency board system is an attractive alternative. Hong Kong's board helped maintain credibility for the Hong Kong dollar during the Asian crisis, but

[4]Unlike Thailand and South Korea, which pegged their currencies to the U.S. dollar, Australia let its currency float. Consequently, the central bank did not have to have as its main priority the defense of the Australian dollar. Instead, the bank eased and Australia weathered the Asian currency crisis—GDP grew by 3.6 percent in 1997 and 5.1 percent in 1998 (Witcher and Wessel 1999: A1).

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Hong Kong did not escape that crisis entirely. To stem capital flight, emerging economies in Asia, and elsewhere, must resolve to establish sound currencies and restructure their financial systems to eliminate moral hazard and crony capitalism. Market alternatives to bank financing should be allowed to develop, argues Wong.

José Piñera, president of the International Center for Pension Reform in Chile and a distinguished senior fellow at the Cato Institute, sees in the Asian financial crisis a unique opportunity for increasing free markets and reducing the scope of government. For him, the main lesson from the crisis is that the "Third Way"—under which free-market principles and the rule of law are compromised by government intervention—is the wrong way toward freedom and prosperity. The failure of government intervention in capital markets and foreign exchange markets—and the failure of industrial policy—indicate that the problem in Asia is not too much capitalism but too much interventionism. The only real choice, therefore, is to move further toward the market. As Piñera writes, "The way out of the Asian crisis is to abandon the Third Way—in both its economic and political dimensions—and introduce more free markets, more civil liberties, and more democratic accountability. Introducing capital controls is not the answer." From his view, "The Asian crisis may turn out to be the fall of a second Berlin Wall, that of a supposedly Third Way to development and freedom."

One important change in the global financial architecture that has already taken place is the creation of the European Monetary Union. *Robert Mundell* and *Charles Calomiris*, both economists at Columbia University, offer insights into the future of the euro as an important international currency. Mundell, an early proponent of the euro, is optimistic that "the dollar-euro exchange rate is going to become the most important price in the world." He believes there will be a strong incentive "to stabilize and reduce fluctuations" in that price and that Japan will want to keep its currency in line with the euro-dollar rate. Thus, he predicts "that by 2010 we will be back to a world where we get more fixed exchange rates, and the International Monetary Fund will be dragged back to its original function." Calomiris, on the other hand, predicts that political factors will play havoc with the euro, as "soft-currency" countries threaten to exit the union unless the European Central Bank agrees to accommodate their excessive government spending by monetizing their fiscal deficits. He believes that the clash between hard- and soft-currency countries will cause increasing tension within the European Monetary Union and lead to its eventual collapse.

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William Poole, president of the Federal Reserve Bank of St. Louis, concludes the volume by making the case for zero inflation. He thinks that "zero is a very nice number" and that the arguments for moderate inflation are misleading and incorrect. Experience has taught that economic growth depends on real, not monetary, forces, and that even mild inflation can distort investment decisions and misallocate resources. For those and other reasons, Poole argues that "zero inflation should be the paramount objective of monetary policy."

Monetary Institutions and Incentives

The currency crises of the 1990s have all dealt with discretionary government fiat monies. Establishing a currency board system or moving to freely floating exchange rates will help in specific cases, but the underlying problem of a unit of undefined value still haunts the global monetary order. That is why Poole's focus on a rules-based monetary regime is important. Attention needs to be directed toward fundamental monetary institutions and how alternative monetary regimes affect incentives and behavior. And that is why Leland Yeager's opening quote is so appropriate: "The key to avoiding crises is not international gimmickry. Instead of fiddling with exchange-rate arrangements, policymakers should pay attention to the currencies themselves."

Real reform of the global financial architecture would mean a much smaller role for what Yeager (1998: 262) calls the "big players" (governments, central banks, and international organizations that try to design the global financial architecture) and a much larger role for private traders and the spontaneous market order. In his view,

> Fundamental reform . . . would avoid sudden unpredictable changes in policy regimes and in official transactions; it would hold down the scope of large centralized decisions, whose effects are harder to cope with than the gradually occurring cumulative effects of innumerable decentralized private decisions; it would reduce the role of official big players on whose dominant decisions the changeable expectations of the public focus. It would provide money of stable or at least of predictable purchasing power [Yeager 1998: 265].

The way to do that is to introduce more freedom and more competition into the money-supply process and let people choose the best currencies. That is an idea F. A. Hayek and others have advocated, but that all governments oppose (see Hayek 1976, 1978; Yeager 1997). With innovations in information technology and with financial deregulation, however, the money of the 21st century may well be private currencies of defined values rather than uncertain government fiat monies (see Dorn 1997).

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For the present, "international gimmickry" continues, with the most recent example being the IMF's new "Contingent Credit Line," designed to assist sound developing economies *before* they run into trouble. But preapproving a country for billions of dollars in credit for use during a possible crisis, provided that country meets certain standards, is a recipe for increased moral hazard. The new facility is based on the myth of contagion and, like the current facilities, will likely lead to more, not fewer, crises—as long as pegged exchange rates, the IMF, and discretionary central banks prevail.

Such gimmickry should not be allowed to crowd out a discussion of real reform. The papers in this volume remind us that getting institutions and prices right is essential for economic development. Private property, limited government, and sound money matter greatly for freedom and prosperity. All systems are imperfect, so there will always be tradeoffs in the choice of monetary and exchange-rate regimes. The central issue is whether market-led development or state-led development will prevail—there is no viable Third Way.

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Building an International Financial Architecture for the 21st Century

Lawrence H. Summers

Building a successful global financial architecture for the next century will involve a great many challenges—for example, establishing the role of the euro and expanding the World Trade Organization. I want to focus on just one of those challenges: creating a safe and sustainable system for the flow of capital from the developed to developing countries. This is not an easy problem. The most rose-tinted consideration of the record of investing in developing countries would admit that it has a checkered past. Ever since the South Sea Bubble there have been recurrent episodes where investors' initial enthusiasm turned to panic—and boom turned to bust.

The postwar history of global capital flows can be summarized as several decades of little or no international capital flows, followed by a wave of petrodollar lending that halted in Mexico City in 1982, followed after a pause by the flood of capital to emerging economies in the 1990s—a flood which we now see turned into reverse.

So the problem of how to establish the means for safe and sustainable capital flows to the less developed countries is not one to which the world was alerted with the collapse of the Thai baht—or the Mexican peso. But we face this challenge today at a time when it has taken on unprecedented desirability and importance for the world's aging population.

The developed countries are now crossing the threshold into an era of increasing rates of retirement and a much lower rate of growth in the labor force. Negative population growth is already a fact in some European countries and the investment of retirement saving is becoming a critical concern. When all of the world's population growth over the next 25 years—and the lion's share of its growth in productivity—will take place in the developing countries we are heading into

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Lawrence H. Summers is Deputy Secretary of the U.S. Treasury.

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a period when there will be exceptional global benefits to the transfer of capital, expertise, and know-how from the developed world to the developing world.

We have lately had a taste of the potential this offers. When history books are written 200 years from now about the last two decades of the 20th century, I am convinced that the end of the Cold War will be the second story. The first story will be about the appearance of emerging markets—about the fact that developing countries where more than three billion people live have moved toward the market and seen rapid growth in incomes. For the first time in human history, living standards for huge populations have quadrupled or more in a single generation.

If the degree of convergence between developing and developed countries in recent years stands out in 20th century economic history, it is hard to believe that it is not related to the very substantial increases in economic integration that have occurred—and increases in foreign investment, trade finance, and portfolio investment are an important aspect of that integration.

Ongoing Reform of the International Financial Architecture

Building a more effective international financial architecture that can ensure that capital flows are sustainable as well as strong is of profound importance around the world. It matters for economic growth in the developing world and, as we saw in the 1980s in a very powerful way, it matters for the stability of our own financial system.

This has been a priority for the United States and the other industrial countries since President Clinton's call for reform at the Naples Summit. And there have been some significant results, including:

- The norm of transparency has come to be more widely accepted with the development and continued refinement of the IMF international data dissemination standards and international agreement, for example, on the need for better information on the true state of central banks' balance sheets.
- Emerging countries have been brought into a broad-based initiative to raise the quality of banking supervision and regulation in emerging economies, with the development of the Basel core principles for effective banking supervision and similar international standards for securities firms and others.
- The Bretton Woods system has been recapitalized with an increase in IMF quotas and the creation of the New Arrangements to Borrow. And these institutions have made important innova-

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tions, with moves to become more transparent and accountable, with premium rate lending on large IMF loans, and with a new recognition at the World Bank of the importance of issues such as good governance, social safety nets, and the prevention of corruption.

These are important developments, but we have seen too many financial crises in recent years to let matters rest there. In October 1998, President Clinton joined the meeting of finance ministers and central bank governors of key industrial and emerging nations held during the IMF and World Bank meetings in Washington. The reports presented there will carry work forward on transparency, financial stability, and crisis resolution.

Major Questions Going Forward

Economists and historians will debate what caused the crises in Asia and Russia for many years to come. But it is fair to say that the debate has focused on four key problems: (1) weak domestic financial systems; (2) imprudent borrowing and lending; (3) inconsistent macroeconomic and exchange rate policies; and (4) in face of difficulties, problems of confidence and lack of liquidity in markets. Each of these factors points to areas that the international community will need to address going forward.

How to Build Sound Domestic Financial Systems in Emerging Economies

Empty office buildings in Houston, record levels of nonperforming loans in Japan, and the need for nationalization of most banks in sober Scandinavia remind us that no one has figured out how to regulate financial systems soundly or is well positioned to offer definitive answers.

That said, if there is a common element in the emerging market financial crises we have seen, it is a large amount of short-term borrowing inefficiently intermediated into low-return investments because financial systems functioned poorly. This, in turn, was the precursor to major confidence problems later on.

Among other things, making these systems work better will involve:

- Pressing for greater opening of domestic financial markets to foreign providers of financial services—and the experience and greater diversification that they afford. Hungary was a pioneer in moving to encourage foreign entry to its market in 1989 and has since reaped the benefits to build probably the deepest,

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most diversified financial system in Central Europe. Argentina's experience since 1995 holds similar lessons.

- Following up on the agreement of the Basel principles, with effective surveillance of national authorities' progress toward implementing these principles and building more effective systems. In improving surveillance and regulation, it may be that market-based approaches such as subordinated debt requirements need to be given consideration as potential supplements to traditional regulatory approaches.
- Curtailment of domestic moral hazard in emerging economies, which in turn means the creation of more effective domestic deposit insurance systems, better domestic bankruptcy laws, and a much greater emphasis on arms-length transactions. Inflows in search of fairly valued economic opportunities are one thing. Inflows in search of government guarantees, or undertaken in the belief that they are immune from the standard risks, are quite another.

It is easier to say how emerging markets should improve their financial systems than it is for their governments to bring about change or to figure out how the surveillance of the IMF and other institutions can best be used to motivate change. These issues will require considerable thought going forward.

Reducing Imprudent Borrowing and Lending

Domestic financial systems can and must be improved. But the root cause of crises is not so much the weakness of financial systems as it is the inflow of capital that is excessive relative to the maturity of the system in which it must be absorbed. This raises a variety of more macroeconomic questions about the flow of international capital.

Countries need to calibrate their efforts to seek capital to the capacity of their domestic financial systems. It bears emphasis that where foreign capital has contributed in a measurable way to the onset of these crises it has not been a matter of countries swamped by unrequited foreign inflows—but of countries positively digging a path to their own door:

- We saw this in Mexico, with the increasing resort to issuing dollar-denominated Tesobonos in the lead-up to the crisis in 1994;
- We saw it in Thailand, in the tax breaks on off-shore foreign borrowing which helped encourage Thai banks to take on excessive foreign debt;
- We saw it in Korea, where discriminatory controls kept long-term capital out and ushered short-term capital in;

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- We saw it in Russia, with the government's increasing efforts to attract foreign investors to the domestic market for GKOs.

While excessive efforts to attract hot money can clearly end in disaster, it would be a mistake to infer that restrictions on securitization, illiquidity, or the resistance of financial innovation necessarily promote stability. Those with a tendency to blame problems on hot money and short-term speculation need to confront the observation that the largest financial sector crisis we have seen in the 1990s—that of Japan—has occurred in a system that has historically been most closed and "long-termist" in its approach. And they need to reckon with the fact that the most reliable source of major financial disturbances in the modern era has been the market for real estate—one of the most illiquid and long-term assets around.

There are a variety of difficult issues that arise in relation to the proper pacing of capital account liberalization and effective prudential management. And there is no question that stronger prudential management will involve measures that will have the effect of preventing flows that might otherwise have occurred.

But we should all be able to agree on the danger of approaches to joining the global financial system that involve denying a country's own citizens the capacity to convert their own currency and invest abroad. Such measures represent substantial intrusions on freedom. They make unsustainable policy errors more tempting. They repel new capital inflows. And, in the age of the Internet, they are unlikely to be successful in the long run.

Of course it is important to recognize, in situations where more money is borrowed than can be well used, that every credit has both a lender and a borrower. And certainly recent experience has been chastening to developers of risk management systems everywhere. In this context I have wondered lately what advice a sophisticated value-at-risk analysis would offer based on past correlations about the need to anticipate two major league baseball players hitting more than 65 home runs in a single season.

As we consider the building of more effective international supervision systems and the continued evolution of risk-weighting within the Basel system of capital standards, it will be important to think about how these tools can best be attuned to systemic stability. But, at a time when international integration is so important, it will be critical not to take steps that will dramatically raise the obstacles to international lending relative to similar-risk domestic investments.

Properly pacing capital inflows with the development of a country's financial system is important for stability. But the best outcomes will

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come with rapid strengthening of financial systems and substantial capital inflows over time. And, with the right kinds of prudential regulation and risk management, the volumes of capital we have seen in recent years can be sustainable. After all, as Alan Taylor (1996) has shown, the flow of capital to developing countries as a share of both borrowers' and lenders' GDP was substantially greater a century ago than it is today.

The Right Kind of Exchange Rate Regimes

The kind of economists that migrate to the Cato Institute are united on many tenets of economic theory and practice yet divided on the management of money in its international aspect. Some are with Milton Friedman in treating exchange rates as a price—and a price that should be flexible for the same reasons that others are. For others, money and its exchange is a promise—one that should be fixed and that should not be broken or devalued.

The choice between these two poses enormous difficulties. But we can all agree that where it is a promise, the promise should be maintained—and that treating it as a promise, then breaking it, is probably the worst of all options. There is no single answer to exchange rate dilemmas. Indeed, the core proposition of monetary economics is a trilemma: that capital mobility, an independent monetary policy, and the maintenance of a fixed exchange-rate objective are mutually incompatible. I suspect this means that as capital market integration increases, countries will be forced increasingly to more pure floating or more purely fixed regimes.

To be sure, the grass is always greener elsewhere. Some fixed rates have built up pressure like a dam—and wreaked devastation on the economic landscape on breaking. Yet the present enthusiasm in Mexico for the notion of dollarization underlines that floating rates are fine, except for where they float to.

In light of the difficulties we have seen in recent years, the question facing the supporters of freely floating rates will be how to find a way for governments to establish a disciplined and transparent policy framework without a fixed exchange rate that provides a clear signal—particularly in a post-crisis environment. And the question for those who see no alternative in these settings must be how to reconcile that need for stability with the fact that all the work done by years of exchange rate commitments to markets can be undone by four days trading in exchange markets.

Although there is no single answer, I suspect that the European experiment with economic and monetary union will influence views and choices that are made in the future. What is important going

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forward will be the recognition that the contagion caused by discontinuities gives the international community an even larger stake in the right choices being made—and that the approach that the international community takes will be very important to their success.

The Right Systems for Crisis Response

It is important always to remember that far and away the best response to a financial crisis is to prevent it. We should not hold out too much hope that any mechanism for crisis response will ever offer anything approaching complete palliation of the adjustment costs of investors deciding that at current prices they wish to move 10 percent of GDP out of a country tomorrow.

Crisis response mechanisms have an ex post aspect, in that we want to respond well to crises, and an ex ante aspect because the decisions people make will be influenced by the fact that they exist.

In this context there is perhaps a useful analogy to be made between the dilemmas involved in responding to financial crises of countries and those involved in responding to the difficulties of individual institutions:

- On the one hand, the danger of bank runs, multiple equilibria, and self-fulfilling prophecies provides a case for providing liquidity where credit shortages are not fully justified by the fundamentals. That is why the Federal Reserve was established. And that is why deposit insurance of some kind is a feature of almost every national financial system.
- On the other, market discipline is the best means the world has found to ensure that capital is well used. And the inevitable byproduct of the confidence instilled by the availability of emergency capital—indeed, in a sense the goal of mechanisms such as deposit insurance—will be some blunting of investor discipline, and some greater preparedness to leave money invested when prudence might otherwise have dictated taking it out.

In a sense, moral hazard is the mirror image of contagion. When the availability of a supply of capital raises confidence and investment, it can either be called confidence that reduces contagion, or it can be called moral hazard.

Closely related to this is the notion that it is essential to distinguish problems of liquidity from problems of insolvency. When liquidity elements are dominant, it is the irony of financial crises that while the problem may have been caused by too much lending, the solution may lie in more lending taking place. Of course, where the solvency

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element is dominant, more lending is wrong and the challenge is to allocate burdens among creditors and write down debts accordingly.

In academic models the distinction between liquidity and solvency crises is clear. In the real world, the distinction is difficult to draw even in hindsight—and even more difficult to draw in advance. It is not surprising, therefore, that the actual response to financial crises often involves a combination of subordination of old claims and their extension or reduction, and the provision of new finance.

How best this process should be managed in the future and how these elements should be combined is a central issue in thinking about how the IMF should function and what its scale should be. Even with the recent increase, it is striking to recall that if IMF quotas represented the same share of GDP today as when it was founded they would be five and a half times larger than they are.

Two recent developments have strengthened the IMF's capacity for responding to financial crisis problems: the Supplementary Reserve Facility providing that when large quantities of finance are provided to respond to pressure from capital inflows, a premium will be charged; and the recent agreement that in certain very specific circumstances the IMF could lend into arrears. And presently discussions are under way about the possibility of providing contingent finance to countries to help contain contagion.

Suggestions that the IMF should precommit to provide finance to countries that conform to various standards of macroeconomic conduct and financial prudence have lately attracted considerable attention. Among the many questions they raise are a problem akin to those raised by narrow banking proposals—about the credibility of promises not to support important institutions or countries outside the system—and important concerns about moral hazard.

In the real world it is perhaps inevitable that ex post conditionality will fill the gap between the promise not to reward imprudence and the realities of contagion. But in imposing conditions ex post there is the challenge of providing confidence to markets while at the same time providing a spur to necessary reforms. This will involve a difficult balance, both in the setting of conditions and the timing of disbursements.

Conclusion

I have stressed the international financial architecture, which is obviously very important for the way the global economy functions. But no one should lose sight of the fact that the most important determinant of every country's fortunes is the policy choices of its

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people and its government. We can seek to create the best structure and best environment possible, and the international community can make a contribution when problems come. But none of this is a substitute for strong, determined action of countries to maintain stability and to address instability when it comes.

I have touched on a number of the economic issues involved in thinking about the financial system of the future. But it may be that the most profound issue is a political one. Just as much greater integration in Europe has led to pressures for more pan-European decisionmaking, it is inevitable that at the global level tensions between integration and sovereignty will arise. But if recent events are a testament to the challenges that such tensions present, they are no less a confirmation of the critical importance of their being overcome.

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Reshaping the Global Financial Architecture: Is There a Role for the IMF?

William A. Niskanen

The Present State of the Debate

The future of the International Monetary Fund (IMF) in the new global financial architecture has received much attention. In May 1998, I testified on this issue to the Joint Economic Committee on a panel with George Shultz, Paul Volcker, and Lawrence Lindsey. My own testimony (Niskanen 1998) elaborated on the conclusion of an important paper by Columbia University economist Charles Calomiris (1998: 276) that, "The principal lesson of the recent bailout programs managed by the IMF and the U.S. government . . . is the vital need for all parties . . . to find a credible way to commit *not* to sponsor such counterproductive bailouts." I observed,

> The characteristic IMF response to this type of criticism, of course, is that the conditions for receiving IMF credit induce the type of reforms that are necessary to avoid a future crisis. In a few cases, this has been successful. The larger record, however, does not provide a basis for optimism. Most developing country governments, once the recipient of IMF's subsidized credit, have become loan addicts. As noted earlier, most of these governments have relied on IMF loans for more than two decades, despite the conditions for receiving these loans and the usual two-to-five year maturity of these loans.

And I concluded,

> Maybe we don't need the IMF—that is now the judgement of former Treasury secretaries George Shultz and William Simon and the former chairman of Citicorp Walter Wriston. I am willing to defer judgement on this issue. In the meantime, Congress should not approve any *additional* funds for the IMF, at least until some of the broader questions are addressed.

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William A. Niskanen is Chairman of the Cato Institute.

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At that hearing, there was broad agreement that additional funding should be conditional on a major reform of the IMF without much agreement on the details. Paul Volcker provoked the most controversy by asserting that the IMF would be more receptive to reform if Congress first approved the additional funding. As is often the case, the recent resolution of this issue was a compromise of those two positions: Congress approved additional U.S. funding of $18 billion in exchange for a promise by the administration and the other major IMF member governments to seek specific reforms.

The Case for Abolishing the IMF

Since that hearing, my views on this issue have evolved from no more funding without IMF reform—to no more funding, period—to no more IMF. For I have concluded that *the IMF cannot perform the role that the member governments expect of it.* As they sing over at the Birchmere, "Walk through this world with me."

First, the IMF is institutionally incapable of being an effective lender of last resort. The IMF cannot create high-powered money or act quickly enough to prevent a liquidity crisis. And the IMF cannot have sufficient information to distinguish between an illiquid bank and an insolvent bank. As summarized in an article by UCLA economist Deepak Lal (1998: 18),

> [The IMF] can lend only after lengthy negotiations with a country's government and with the approval of its board. [And] it has no way of sorting out the 'good' from 'bad' loans, for instance made by foreign banks to residents in the country, and to liquidate the latter. The lender of last resort function for the money centre banks involved in foreign lending must therefore continue to be provided by their parent central banks.

Second, the IMF has not proved to be generally effective in promoting the type of economic policies that are necessary to avoid a future financial crisis. Mexico, for example, has had a financial crisis each presidential election year from 1976 through 1994. And, as mentioned before, many developing country governments have relied on IMF loans for more than two decades. The IMF was first established to provide short-term balance of payment financing in a fixed exchange rate regime. Over time, the IMF has evolved into an international economic development consultant, using subsidized loans to induce developing country governments to adopt policies that are already presumably in their best interests. This bureaucratic mission creep might be satisfactory if the IMF had proved effective in its new role. But it has not. The difference in per capita incomes between the rich

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and poor nations has continued to increase as have the frequency and magnitude of financial crises.

And third, the extended post-crisis negotiations over the conditions for receiving an IMF loan risk turning a liquidity crisis into a solvency crisis. If adequate IMF loans are not made quickly enough to maintain a stable exchange rate, domestic borrowers end up owing more in the domestic currency to meet the obligations of loans made in a foreign currency. For domestic borrowers, loans that were viable at the prior exchange rate become an unserviceable burden at the new lower exchange rate. One solution to this problem, as noted by Lal (1998), would be to require that all foreign loans be made in the domestic currency, shifting the exchange rate risk from the borrower to the lender; this would reduce foreign borrowing by increasing domestic interest rates by the amount necessary to compensate for the exchange rate risk but would substantially reduce the risk of bankruptcy by the domestic borrower. As long as domestic banks and other firms borrow abroad in a foreign currency, the only solution to this problem would be for the IMF and money center banks to make adequate loans quickly enough to avoid a collapse of the exchange rate.

Conclusion

There may be a valuable potential role for the IMF—to act as an international lender of last resort in every role other than creating new base money. But this would require a profound change in the way that the IMF operates. The conditions for eligibility for IMF loans would have to be established on a nondiscriminatory basis and announced before a crisis, rather than negotiated on a discriminatory basis after the crisis; this would require that the IMF refuse to make loans to a government that did not meet these announced pre-crisis conditions. Consistent with Bagehot's time-tested advice, the IMF should then be prepared to make large loans quickly to any solvent but illiquid eligible borrower but at a penalty interest rate and matched by the borrower's best collateral.

But this seems like too much of a change of institutional culture. The IMF would have to replace most of its economists with bankers, to forego its economic consulting role in exchange for being the manager of an international discount window and, most difficult, to be willing to tell some of its member governments that they are not eligible for IMF loans.

One alternative would be to let the IMF go its merry way but with a clear signal that there would be no additional funds. But it is just that type of regulatory forbearance that led to the S&L crisis and a

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large taxpayer bailout. A better alternative, I now conclude, is to abolish the IMF.

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Reflections on Exchange Rate Regimes

Steve H. Hanke

The dramatic events in Asia, Russia, and Brazil during the past year have generated a torrent of commentary about exchange rates, hot money, exchange controls, and dollarization. As someone whose views about exchange rates in Asia have been vindicated (*Far Eastern Economic Review* 1998), who predicted that the Russian ruble would collapse shortly after midyear (Hanke 1998a), and who concluded that the Brazilian real would fall apart after the October 1998 presidential elections (Hanke 1997), I offer my thoughts as to why most of the commentary has either been misinformed or dead wrong.

Officials at the U.S. Treasury and the International Monetary Fund have misdiagnosed the patients and prescribed the wrong medicine in Asia, Russia, and Brazil. But that has not stopped them from telling a different story, one that is contradicted by the facts. In late January, for example, U.S. Deputy Treasury Secretary Lawrence H. Summers remarked, "The financial turmoil that has affected Asia, Russia, and Brazil in the past year would have been worse without the IMF" (Dow Jones 1999).

The World's Changing Currency Landscape

To put reflections on exchange rates into perspective, it is instructive to consider recent changes in the world's currency landscape. Its morphology has been in a state of flux during the decade of the 1990s. Volatile hot money flows have battered pegged exchange rate regimes, causing volcanic-like eruptions in the European Exchange Rate Mechanism (1992–93), the Turkish lira (1994), the Mexican peso (1994–95), the Thai baht and the other Asian currencies (1997–98), the Russian ruble (1998), and the Brazilian real (1999).

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Steve H. Hanke is Professor of Applied Economics at the Johns Hopkins University and an Adjunct Scholar of the Cato Institute.

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Balkanization has also been a prominent force in the 1990s. With the collapse of the Soviet Union, a large unified currency area was dismembered. In consequence, 15 national currencies officially circulate where the ruble once ruled. Much of the same occurred after Yugoslavia broke apart. Now five currencies circulate as legal tender in a region where one currency used to do the job.

The last time currency balkanization occurred on such a grand scale in Europe was during the monetary chaos that followed World War I. In 1914, Europe had 10 currencies, all with fixed gold parities and fixed exchange rates. By 1920, Europe had 27 paper currencies, none with a gold parity or a fixed exchange rate.

Even more dramatic than the trend toward balkanization has been that of unification. Argentina, Estonia, Lithuania, Bulgaria, and Bosnia have unified their domestic currencies with stronger anchor currencies by establishing currency board systems.[1] And in 1998, Indonesia and Russia flirted with currency board proposals.[2] Those two episodes merit special attention for the light they shed on the international politics of currency reform and the Machiavellian role played by the U.S. Treasury and the IMF. To many observers, the Clinton administration appeared determined to topple President Suharto through monetary chaos (*Singapore Straits Times* 1999). When President Suharto embraced the currency board idea in February 1998, the U.S. Treasury and the IMF opposed the idea and mounted a swift and massive counterattack. The Russian story was quite different, however. In August 1998, the Clinton administration was desperately trying to prop up the ruble and rescue President Boris Yeltsin. That is why a Russian currency board was viewed in a favorable light by the U.S. Treasury and the IMF. They knew that Bulgaria's currency board system had provided a quick fix for the hyperinflating lev in July 1997.

On January 1, 1999, 11 European countries embarked on the greatest monetary experiment of the century by unifying their national currencies and replacing them with a new currency, the Euro. This currency unification was accomplished by establishing a monetary union. The European Monetary Union has been followed by calls to

[1]Until the 1950s, orthodox currency board systems were widely used, particularly in Africa, the Caribbean, and Asia. In 1983, Hong Kong reestablished a currency board system, but it deviated from orthodoxy in several important ways, as do all the currency board systems introduced in the 1990s. All currency board systems have performed well even during civil wars. For a general discussion of currency boards and a more detailed explanation of their main features, see Walters and Hanke (1992).

[2]For a discussion of the Indonesian currency board episode, see Hanke (1998b) and Culp, Hanke, and Miller (1999). For the Russian episode, see Hanke (1998c).

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establish other monetary unions, most notably among the Mercosur countries and among some Asian countries.

In addition to these dramatic changes in the world's currency landscape, Russia and Belarus are negotiating a monetary union in which the ruble replaces the "hare," and Argentina is considering dollarization—that is, officially replacing the peso with the U.S. dollar (Fidler and Warn 1999). Argentina's move has stimulated monetary unification discussions in Central and Eastern Europe, as countries in that region consider replacing their national currencies with the Euro or the U.S. dollar.

Exchange Rate Regimes

There are three types of exchange rate regimes: freely floating rates, fixed rates, and pegged rates. Each type has different characteristics and generates different results. Although floating and fixed rates appear to be dissimilar, they are members of the same family. Both are free-market mechanisms for international payments.[3] With a floating rate, a monetary authority sets a monetary policy, but has no exchange rate policy—the exchange rate is on autopilot. In consequence, the monetary base is determined domestically by a monetary authority. Whereas, with a fixed rate, a monetary authority sets the exchange rate but has no monetary policy—monetary policy is on autopilot. In consequence, under a fixed rate regime, the monetary base is determined by the balance of payments. In other words, when a country's official net foreign reserves increase, its monetary base increases and vice versa. With both of these free-market exchange rate mechanisms, there cannot be conflicts between exchange rate policy and monetary policy. Consequently, balance of payment crises cannot occur. Indeed, under freely floating exchange rates and rigidly fixed rates, market forces act to automatically rebalance financial flows and avert balance of payments crises.

While both floating and fixed rates are equally desirable in principle, it must be stressed that floating rates, unlike fixed rates, do not perform well in developing countries because those countries usually have weak monetary authorities and histories of monetary instability (Hanke 1999). Indeed, currencies in developing countries rarely float on a sea of tranquility. Knowledge of this fact would, no doubt, have prompted IMF Deputy Managing Director Stanley Fischer to temper his remarks concerning Indonesia's float of the rupiah. On the day

[3]This explains why Milton Friedman, who is known for his advocacy of floating exchange rates, has also been a strong advocate of currency board systems and fixed exchange rates for developing countries (see Friedman 1973).

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of the float, August 14, 1997, Fischer (1997) proclaimed, "The management of the IMF welcomes the timely decision of the Indonesian authorities. The floating of the rupiah, in combination with Indonesia's strong fundamentals, supported by prudent fiscal and monetary policies, will allow its economy to continue its impressive economic performance of the last several years."

Fixed and pegged rates appear to be the same. However, they are fundamentally different. Pegged rates are not free-market mechanisms for international payments. Pegged rates, such as those that were employed throughout most of Asia and in Russia and Brazil before the recent currency crises, require a monetary authority to manage both the exchange rate and monetary policy. With a pegged rate, the monetary base contains both domestic and foreign components. Unlike floating and fixed rates, pegged rates invariably result in conflicts between exchange rate and monetary policies. For example, when capital inflows become "excessive" under a pegged system, a monetary authority often attempts to sterilize the ensuing increase in the foreign component of the monetary base by reducing the domestic component of the monetary base. And when outflows become "excessive," an authority attempts to offset the decrease in the foreign component of the base with an increase in the domestic component of the monetary base. Balance of payments crises erupt as a monetary authority begins to offset more and more of the reduction in the foreign component of the monetary base with domestically created base money. When this occurs, it is only a matter of time before currency speculators spot the contradictions between exchange rate and monetary policies and force a devaluation.

Hot Money and Exchange Controls

Hot money flows are principally associated with pegged exchange rates. Many analysts have misdiagnosed the hot money problem because they have failed to appreciate this all-important linkage. In consequence, they have prescribed exchange controls as a cure-all to cool off the hot money. That prescription treats the symptoms. It fails to treat the disease, which is pegged exchange rates. Until pegged rates are abandoned, there will be volatile hot money flows and calls to cool the hot money with exchange controls.

Paul Krugman (1998) is the most notable promoter of exchange controls. Alas, Malaysia's mercurial Prime Minister, Mahathir Mohamad, took Krugman's bait and imposed draconian controls on September 2, 1998. Krugman has now washed his hands of that deed, which is perhaps the most devastating critique of controls. But there is more.

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Currency convertibility is a simple concept. It means residents and nonresidents are able to exchange domestic currency for foreign currency. However, there are many degrees of convertibility, with each denoting the extent to which governments impose controls on the exchange and use of currency.

The pedigree of exchange controls can be traced back to Plato, the father of statism. Inspired by Sparta of Lycurgus, Plato embraced the idea of an inconvertible currency as a means to preserve the autonomy of the state from outside interference. It is no wonder, therefore, that the so-called Red-Brown (communist-fascist) coalition in the Russian Duma has rallied around the idea of exchange controls and an inconvertible ruble. This also explains why the leadership in Beijing finds the idea so user friendly.

The temptation to turn to exchange controls in the face of disruptions caused by hot money flows is hardly new. Tsar Nicholas II first pioneered limitations on convertibility in modern times, ordering the State Bank of Russia to introduce, in 1905–06, a limited form of exchange control to discourage speculative purchases of foreign exchange. The bank did so by refusing to sell foreign exchange, except where it could be shown that it was required to buy imported goods. Otherwise, foreign exchange was limited to 50,000 German marks per person. The Tsar's rationale for exchange controls was that of limiting hot money flows, so that foreign reserves and the exchange rate could be maintained. The more things change, the more they remain the same.

Before more politicians come under the spell of exchange controls, they should reflect on the following passage from Nobel laureate Friederich Hayek's 1944 classic, *The Road to Serfdom*:

> The extent of the control over all life that economic control confers is nowhere better illustrated than in the field of foreign exchanges. Nothing would at first seem to affect private life less than a state control of the dealings in foreign exchange, and most people will regard its introduction with complete indifference. Yet the experience of most continental countries has taught thoughtful people to regard this step as the decisive advance on the path to totalitarianism and the suppression of individual liberty. It is in fact the complete delivery of the individual to the tyranny of the state, the final suppression of all means of escape—not merely for the rich, but for everybody [Hayek 1944: 92n].

Hayek's message about convertibility has regrettably been overlooked by many contemporary economists. Exchange controls are nothing more than a ring fence within which governments can expropriate their subjects' property. Open exchange and capital markets,

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in fact, protect the individual from exactions, because governments must reckon with the possibility of capital flight.

From this it follows that the imposition of exchange controls leads to an instantaneous reduction in the wealth of the country, because all assets decline in value. To see why, it is important to understand how assets are priced.

The value of any asset is the sum of the expected future installments of income it generates discounted to present value. For example, the price of a stock represents the value to the investor now of his share of the company's future profits, whether issued as dividends or reinvested. The present value of future income is calculated using an appropriate interest rate that is adjusted for the various risks that the income may not materialize.

When convertibility is restricted, risk increases, because property is held hostage and is subject to a potential ransom through expropriation. As a result, the risk-adjusted interest rate employed to value assets is higher than it would be with full convertibility. Investors are willing to pay less for each dollar of prospective income and the value of property is less than it would be with full convertibility.

This result, incidentally, is the case even when convertibility is allowed for profit remittances. With less than full convertibility, there is still a danger the government will confiscate property without compensation. That explains why foreign investors are less willing to invest new money in a country with such controls, even with guarantees on profit remittances.

Investors become justifiably nervous when they expect a government may impose exchange controls. Settled money becomes "hot" and capital flight occurs. Asset owners liquidate their property and get out while the getting is good. Contrary to popular wisdom, restrictions on convertibility do not retard capital flight, they promote it.

This type of capital flight (and unofficial dollarization) has been occurring on a grand scale in capital-starved Russia. Indeed, Russians swapped $13 billion worth of rubles for greenbacks in 1997, a year in which the dollar-ruble rate was stable and inflation was falling rapidly. This unofficial dollarization amounted to a capital export that exceeded all capital imports to Russia in 1997. The actions of the Russian people indicate that, among other things, they anticipated the possibility of the imposition of exchange controls.

Restrictions on convertibility also promote other noxious activities. For example, if capital account convertibility is restricted or limited and convertibility on the current account is allowed, a two-tier currency market will be either formally or informally established. In that case, the "investment currency" will trade at a premium over the

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price of the relevant foreign currency on the official market for current account transactions. With two prices for the same currency, there are profits to be derived from having capital account transactions "reclassified" as current account transactions. That ad hoc reclassification can usually be bought by crony capitalists, for a price.

Full convertibility is the only guarantee that protects people's right to what belongs to them. Even if governments are not compelled by arguments on the grounds of freedom, the prospect of seeing every asset in the country suddenly lose value as a result of exchange controls should give policymakers pause.

Currency Unification via a Currency Board or Dollarization

As we enter the 21st century, globalization (the liberalization of financial and trade flows) is threatened. Volatile short-term capital flows are identified as the problem and exchange controls the remedy. That prescription, which is based on a wrongheaded diagnosis, will lead to monetary nationalism and the type of economic chaos the world encountered after World War I. The only way to avoid such a disaster is for developing countries to unify their currencies with stronger ones by establishing a currency board or by replacing a national currency with a strong foreign currency (official dollarization).

An orthodox currency board system is a monetary institution that issues notes and coins fully backed by a foreign reserve currency and convertible into the reserve currency at a fixed exchange rate on demand. In addition, an orthodox currency board cannot act as a lender of last resort, does not regulate reserve requirements for commercial banks, only earns seignorage from interest on reserves, and does not engage in forward exchange operations.

Hong Kong's currency board, as well as those established in the 1990s, all deviate in important respects from orthodoxy. While these boards have performed well, something even the skeptics have admitted, they are not trouble free. For example, even though Argentina weathered the storms of 1995, the spread between interest rates on Argentine 30-day loans in pesos and U.S. dollars varied between 0.5 percentage points and 4.4 percentage points during 1998. If the peso-dollar fixed exchange rate was perfectly credible, those spreads should have been close to zero.

The peso-dollar interest rate spreads are not zero because the Argentine currency board deviates from orthodoxy. It engages in lender-of-last-resort activities, regulates reserve requirements for commercial banks, and up to one-third of the dollar-denominated

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reserves it holds to back its monetary liabilities can be held in the form of Argentine government bonds. Also, its foreign exchange reserves can exceed its monetary liabilities, indicating sterilization.

To make Argentina's currency unification with the dollar perfect, President Carlos Menem has suggested that Argentina replace the peso with the dollar. Official dollarization would close the peso-dollar interest rate spreads, peso notes would no longer circulate, and Argentina would no longer earn seignorage from its currency board system. Argentina could easily implement official dollarization by exchanging its dollar reserves for outstanding peso notes and coins and by declaring that all peso assets and liabilities in Argentina be denominated in dollars.

At least 120 countries have officially used the currency of another country at some time. Today, the best-known country that is dollarized is Panama, which did so in 1904. However, there are 27 other countries and dependent territories that currently do not have a national currency and use a foreign one instead. Even though the record unambiguously supports official dollarization as a superior monetary regime, Deputy Treasury Secretary Summers does not seem to like the idea. Indeed he has already confidently asserted that monetary unification via dollarization would not provide a "quick fix" for monetary crises (Fidler 1999).

The Record of Currency Boards and Dollarization

Some analysts fret about the inflexibility imposed by currency boards and dollarization. *The Economist* summarized these sentiments in an article, "The Great Escape," which appeared in the May 3, 1997, issue. That article asserted that currency boards cannot cope with external shocks; that they are vulnerable to surges in inflation triggered by capital inflows; and that with limited lender of last resort capacities, they cannot deal effectively with financial emergencies.

The evidence does not support those oft-repeated assertions. Data from 98 developing countries for the 1950–93 period show that countries with fixed exchange rates experienced growth rates of per capita GDP that were 54 percent greater than those of countries with pegged exchange rates. Furthermore, the variability of those growth rates (as measured by their standard deviations) was virtually identical, indicating that the lack of discretionary monetary policy with fixed exchange rates did not result in any greater incidence or vulnerability to external economic shocks. As for inflation, fixed rates have proved far superior to pegged rates, with average inflation rates being 4.9 times higher in countries with pegged rates and 4.2 times more variable. In

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terms of budget deficits, measured as a percentage of GDP, countries with pegged rates had deficits that were, on average, 65 percent larger and 1.4 times more variable than those of countries with fixed rates. Finally, countries with fixed rates experienced fewer financial emergencies (Hanke 1999).

Conclusion

Until recently, most economists have downplayed currency boards and dollarization as viable reform proposals for developing countries. Many experts simply declared that fixed rates are "inappropriate" or claimed that the facts are "erroneous." There is nothing new here. Indeed, in his book, *Personal Knowledge*, Michael Polanyi (1958: 138) concluded, "The normal practice of scientists [is] to ignore evidence which appears incompatible with the accepted system of scientific knowledge."

With the failure of pegged and floating rates in Asia, Russia, and Brazil, the tide has begun to shift. This shift is welcome and has left me feeling a bit like Winston Churchill on his return from the Boer War, when he remarked, "Nothing in life is so exhilarating as to be shot at without success."

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Increasing Global Financial Integrity: The Roles of Market Discipline, Regulation, and Supervision

Laurence H. Meyer

Recent developments, both at home and abroad, have reinforced the importance of efforts to increase the stability of global banking and financial markets. The central challenge of promoting the stability of the global banking system is sometimes viewed as bringing banking systems around the world up to best practice standards, as exemplified in the supervisory and regulatory frameworks of advanced industrial economies. While this is, to be sure, a priority—at least for internationally active banks around the world—let me offer a more comprehensive framework for thinking about enhancing the stability of the global banking system.

First, best practices is a dynamic, not a static concept. The rapid change in banking markets and practices, and more generally in financial markets and instruments, challenges supervisors and regulators around the world to adapt in order to maintain the effectiveness of regulatory standards and supervisory practices. Best practices simply must get better over time or they will soon not be good enough.

Second, best practices may not be the same for all banking organizations. It is time to think about not only enhancing the contributions of market discipline, reforming capital standards and enhancing supervisory practice at the largest and most complex banking organizations, but also about differentiating how we regulate and supervise these institutions relative to small and medium-sized banks.

Third, we have to continue to work on appropriate global norms and make greater progress in achieving greater convergence to best practices—including, perhaps, different best practices for different

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Laurence H. Meyer is a Member of the Board of Governors of the Federal Reserve System. The views expressed herein are his own and do not necessarily reflect those of the Federal Reserve System.

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classes of institutions—around the world. This means appropriate investments in developing the standards, in technical assistance, and in monitoring compliance.

I am going to apply this broader perspective on global banking to three pillars of an efficient and effective supervisory and regulatory framework for banking: market discipline, regulation, and supervision. First, I will discuss the potential for enhanced disclosure and improved incentives to increase the effectiveness of market discipline in controlling risk-taking by banks. Second, I will discuss the importance of reforming our international capital standards as an example of dynamic best practices. Third, I want to emphasize the important role for bank supervision.

Market Discipline: Information and Incentives

There appears to be a renaissance in appreciation of the contribution of market discipline in banking. This undoubtedly reflects a growing awareness that recent developments in banking and financial markets have made regulatory standards less effective and supervision more challenging, that it may be simply impossible to adapt regulatory standards and supervisory practices fast enough to keep pace with market developments.

Of course, market discipline does not come easy to banking. We start by establishing a safety net for banks, including deposit insurance, access to a lender of last resort, and payment system guarantees. This immediately reduces the incentives of market participants to monitor the risk-taking of banks and, in turn, encourages excessive risk-taking by banks. We then put in place a regulatory and supervisory framework to counter these moral hazard incentives. And, when we are done, we complain about the absence of market discipline. I appreciate that this sounds just a bit contradictory.

I could be more consistent if I urged the dismantling of the federal safety net and the full return to reliance on market discipline. But it is clear that society has made one of those irreversible choices and will not choose to eliminate deposit insurance, the discount window, a Federal Reserve payments system, or bank supervision and regulation. Moreover, my reading of history suggests that, despite the strong indications of the success of market discipline, the cost of the associated financial market disturbances on real economic activity are too high for market discipline to be the sole regulator of banking. I understand opinions differ on this, just as they must when supervisors and regulators make judgments to act at specific times. But, what is worth understanding is that there is now general agreement that moral

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hazard is a significant problem, that the markets are increasingly complex—making it more difficult for supervisors and regulators—and that supervision and regulation have significant costs and inefficiencies. As a result, we must begin to increase our reliance on market discipline both as a governor and as an indicator.

When I talk about market discipline, some hear a call for a substitution of more market discipline for less regulation and supervision. Listen more closely. My concern is that the task of regulation and supervision has become more challenging and we therefore have to increase the effectiveness of our overall regulatory and supervisory framework to keep pace. I am referring here to the increased size, breadth, and geographic scope of banking and to its increased globalization and complexity. I want to achieve this increased effectiveness by enhancing market discipline, modifying our regulatory standards, and adapting supervisory practice. We also want an efficient regulatory framework, one that achieves its objectives at the lowest cost. Where there are opportunities to achieve the same degree of stability through increased reliance on markets and reduced emphasis on regulation and supervision, we should, of course, do so. But right now, my focus is on increasing the overall effectiveness of the framework and in relying as much as possible on market discipline and improved capital standards to get this job done.

It is one thing to extol the virtue of markets and another thing to find ways to make them work more effectively in controlling risk-taking in banking, at least in the presence of the safety net. The time has come to move beyond rhetoric to specific actions. Within the Federal Reserve System we have a variety of working groups and committees working to this end. We also have the benefit of ongoing work and recent reports by the Basle Supervisors Committee and the Group of 22. I expect that these efforts will result in concrete proposals soon.

Market discipline is about information and incentives. Market participants must have access to reliable and timely information on the financial conditions and prospects of banking firms, and both the market participants and the firms must have incentives to respond to this information. With respect to information, we need to consider what additional disclosure would contribute to enhanced market discipline. Providing incentives is important because such incentives can encourage banks to disclose voluntarily the information the market demands.

Two common principles apply to disclosure as well as to regulatory reform and adaptation of supervisory practice. First, banks that want to play in global markets should meet international standards with

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respect to transparency and disclosure. Second, banking systems in developed economies, in turn, should not be resting on their laurels when it comes to transparency and disclosure. Here again "best practices" has to be understood as a dynamic process. The increased complexity of banking, the speed with which risk positions can change, and the increased size and breadth of banking organizations all seem to point to the usefulness of improving disclosure to provide the raw material the markets need to continuously reevaluate changing risk profiles.

Improved disclosures about risk management practices, risk profiles, and risk management performance—coupled with disclosures about regulatory capital and its components, risk-weighted assets, and related matters—could provide transparency that will facilitate market discipline. Timely disclosure of this information would enable market participants and supervisors to better assess how institutions maintain sound capital in relation to their changing risk exposures. Some of these types of disclosures are among those set forth in the recent (1998) Basle Committee report, *Enhancing Bank Transparency*. International disclosure standards should include, for example, guidelines for reporting nonperforming loans, for provisioning for nonperforming loans, and for classifying the quality of loans. Upgrading international banking statistics to provide more detailed data on international exposures would enhance the ability of both supervisors and market participants to assess the vulnerability of domestic banking systems to financial shocks from abroad. It would also be useful to provide better information about the complex activities of the largest, internationally active banks, such as securitizations, credit risk modeling, and credit derivatives.

The second foundation of market discipline is incentives. One promising direction might be to require at least the largest and most complex banks to issue minimum amounts of subordinated debt as a way of enhancing market discipline. To a degree I view this as a metaphor for specific steps to enhance market discipline, to emphasize that we have to move beyond rhetorical praise for markets to specific steps to harness the role of markets in monitoring risk-taking by banks. There may be other approaches that can accomplish this task, as well as or better than subordinated debt. But, right now, I do believe there is considerable promise in a subordinated debt requirement.

An appealing aspect of this approach is that subordinated debt holders, so long as they are not bank "insiders," face only downside risk, and thus their risk preferences are very close to those of the FDIC. Subordinated debt holders would therefore be expected to

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impose market discipline on the bank that is quite consistent with what bank supervisors are trying to do, including encouraging banks to disclose more information about their financial conditions. Observed risk premiums on subordinated debt could perhaps be used to help the FDIC set more accurate risk-based deposit insurance premiums, and such debt would provide an extra cushion of protection to taxpayers. An additional benefit of having subordinated debt traded on the open market, at least if the market for subordinated debt was sufficiently liquid, is that price movements would provide a clear signal of the market evaluation of the bank's financial condition that would serve as an early warning signal to aid supervisors.

Such an approach would most likely be limited to the largest banks for at least two reasons. First, it is the increased size of banking organizations and the financial innovations of the largest and most sophisticated banks that are challenging the effectiveness of the current regulatory and supervisory framework. Second, it is unclear just how deep and liquid a market for bank subordinated debt would be and what access small and medium-sized banks would have to this market. This suggests that an operationally feasible program of mandatory subordinated debt would require a considerable amount of further thought.

Reforming Capital Standards

Market discipline, as I noted, is a complement to the regulation and supervision required by the safety net. The foundation for bank regulation has long been capital standards. Since 1988, these have been international standards as embodied in the Basle Accord.

Capital standards can be thought of as a way of reinforcing market discipline, because they shift more of the risk to shareholders relative to taxpayers. In this way, capital is the closest relative to market discipline among bank regulations. That is the good news about capital standards. The bad news is they are becoming increasingly less meaningful and progressively undermined as a result of regulatory capital arbitrage.

Regulatory capital arbitrage refers to the gaming of the capital standards, the exploitation of loopholes that allows banking organizations to lower the amount of capital for a given level of risk. Regulatory capital arbitrage has been encouraged by the limitations of and excessive rigidity in the current capital standards. To be sure, it serves as a kind of safety valve, preventing the capital rules from distorting bank behavior in noneconomic ways. But capital arbitrage also under-

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mines the effectiveness of our capital rules and creates some economic distortions.

Banks engage in regulatory capital arbitrage mainly through securitizations and credit derivatives. These vehicles offer improved opportunities for banks to manage their risks and liquidity. Securitizations allow banks to transfer the risk of an underlying loan pool to capital markets, retaining their role in the origination of loans, but transferring more of the ultimate funding to the capital markets. Credit derivatives are another vehicle for shifting some of the risk of the underlying loan pool, while avoiding disclosure of an effective loan sale and possibly harming a customer relationship.

There are two problems with the use of securitization and credit derivatives. First, banks often use these vehicles to reduce capital charges by more than they reduce the risk associated with the underlying loan pool. This is the problem of limited transference of risk. Banks generally retain the risk of "first dollar" or "second dollar" loss on the underlying assets via various credit enhancements. Indeed, through devices such as "remote origination" and "indirect credit enhancements" the regulatory capital associated with retained risks can be very low, even zero. As a result, some refinement in the capital treatment of securitizations and credit derivatives is needed to better match the capital with the retained risk by banking organizations.

But the second problem is the more difficult one. Securitizations and credit derivatives are basically exercises in cherry picking. That is, they allow banks to transfer the high-quality assets out of their banking book. Banks do so for good reason, to be sure. They do so because our current capital standards apply the same risk weight to all nonmortgage loans, and the regulatory capital charges for the highest quality loans are often well in excess of the economic capital that banks internally allocate to such loans. In a world of increased competition, banks have to use every opportunity to manage their risks and capital to best advantage. And that means either not originating such high-quality loans or finding ways to make the regulatory capital converge to their estimate of the economic capital of such loans. Regulatory capital arbitrage is a safety valve because it allows banks to stay in the business of making such high-quality loans.

The main problem here is not the reduction in capital charges against the high-quality loans, although this does raise tension with prevailing international capital standards. The most serious problem is the increased risk of the residual loan portfolio, the portfolio that has been effectively stripped of its high-quality assets for which regulatory capital exceeds economic capital. The remaining loans, to the extent this process has been carried out to its logical conclusion, all have

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economic capital equal to or in excess of the regulatory capital charges. The 8 percent capital charge for the average loan portfolio may, as a result, be quite inadequate for the residual higher-risk loan portfolio. On the other hand, the 8 percent risk-based capital standard may still be adequate for banks that do not engage in cherry picking via securitizations and credit derivatives. Therefore, as we move toward reform of the international capital standards, we should not necessarily apply the same capital standards to all banks.

The point here is not to blame banks for engaging in regulatory capital arbitrage. The fact is that regulatory capital arbitrage is an outgrowth of the considerable resources that banks have devoted to better measuring, pricing, and managing of risk. And it is also a response to serious shortcomings in our international capital standards. The solution is not to reign in banks, but to catch up to banks, specifically to reform our international capital standards in a way that takes advantage of some of the advances in credit risk measurement and management in the industry.

The Federal Reserve has been actively engaged in analyzing the emerging tensions between bank practices and regulatory rules, and has been working toward recommendations for reform. Regulatory capital standards, at least those that apply to internationally active banks, require international consensus. The Basle Supervisors Committee, under the leadership of William McDonough, president of the Federal Reserve Bank of New York, is moving toward active discussion of reform of the Basle Accord, and the Federal Reserve will be an important contributor to that deliberation. Without laying out the specifics of a reform effort, the direction must be to ensure that regulatory capital charges, especially those related to the banking book, better match economic risks.[1]

Today the same capital charge is assessed against a loan to a AAA-rated company as to a loan to a junk-rated company. As a result, banks tend to have very similar regulatory capital ratios despite the fact that they have quite different risk profiles. Fortunately, the largest and most sophisticated banks can and do differentiate between their loans for the purpose of assigning internal economic capital as part of credit risk management. Regulators have to take advantage of the same improvements in credit risk measurement and management to achieve this improved matching of capital to underlying risks. The problem is that, at this point, there is a considerable diversity in the quality of such risk measurement and management across banks and some seri-

[1]For several excellent staff papers on these issues, see the Federal Reserve Board's web site (http://www.bog.frb.fed.us).

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ous limitations to the robustness of internal risk measurement models. So we need to encourage both continued advances in risk measurement and management and convergence toward best practice within the industry, at least for the largest, most complex, and internationally active banks. The fact is, we may not yet be where we need to be in terms of credit risk measurement and management to implement a new capital standard that effectively resolves problems associated with regulatory capital arbitrage.

Thus, as we move toward a reform of international capital standards that harnesses the risk measurement improvements in banking, we need parallel efforts in credit risk measurement and management within the banking industry. If we can match these two efforts, we will hopefully be able to achieve meaningful reform of our capital standards. This would hopefully allow us to eliminate or at least significantly reduce incentives for regulatory capital arbitrage, ensure that risk-based capital ratios are more meaningful, and enhance the role of capital standards as the foundation for bank regulation.

The Importance of Supervision

At its best, regulation is a rather blunt instrument and, as a result, in the United States great emphasis has been placed on bank-by-bank supervision, including on-site examinations. Historically, U.S. examiners focused almost solely on uncovering deteriorated or troubled risk positions; in effect, they carried out a "classified assets" review. But we recognize now that good supervision is proactive. It is, of course, important to force banks to recognize problems promptly when they occur; it is even better to make sure that the probability of a problem occurring is contained to begin with. To this end U.S. supervisors now conduct examinations of bank risk measurement and management processes, not just examinations of bank assets. This also reflects the new dynamics of bank risk-taking, the prospect of rapid change in underlying risk because of the changed nature of bank practices, changes in the technology that speed changes through markets, and changes in financial instruments. The old approach was more like taking a snapshot of troubled assets at a point in time and returning the following year for another picture. The new approach is one that features monitoring of the systems and procedures used to measure risk by the bank on a continuous basis, with the details of the examination process tailored to the complexity of the transactions and to the areas within a banking organization where the greatest risks are concentrated.

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The pace at which financial innovation is occurring is leaving gaps in banking regulation, which will take time to fill. There is no alternative but for supervisors, during this interval, to be more alert and to recognize the greater role for supervisory discretion. In a recent supervisory letter, for example, the Federal Reserve encouraged its supervisors to be sure that the robustness of a bank's credit risk management was scaled appropriately to the complexity of its operations. Specifically, banks that aggressively participate in cherry picking via securitizations and credit derivatives should be expected to have in place a credible system of internal credit risk rating and should be prepared to assess the economic capital appropriate to the residual banking portfolio.

Having said all this, we have been reminded over and over again that some things change, but others stay the same. It is important to recognize, as recent experience has forced us to, that new financial instruments often involve the same old types of risk. A good example is derivatives. U.S. banks, for example, hedged positions in rubles without adequately considering the credit quality of the hedge counterparties, specifically the Russian banks that were the counterparties to foreign exchange hedges. In the case of derivative positions that banks had with hedge funds, the risk was not so much the potential for rapid change in the value of the underlying position, given that banks insist on collateral backing on contracts for which they are in the money and also generally hedge these positions. However, assessment of the risk of the counterparties remains an important task, because when a counterparty defaults banks lose one end of their hedged positions and must quickly replenish such positions in volatile and illiquid markets. And, of course, in Asia, Russia, and elsewhere banks lent to domestic businesses with poor underlying financials, sometimes because of encouragement of the government, sometimes as a result of a system of connected lending, and often because of expectations that domestic governments would bail out the important businesses. Put differently, banks most often still lose money the old-fashioned way—poor credit judgments and bad luck. We should not lose sight of this as we adopt new procedures and techniques.

Whether for the old or new techniques and problems, the culture of on-site supervision is much less strong in other countries and in some cases is almost nonexistent. Indeed, in some cases, supervision consists entirely of reviewing publicly available financial statements to determine compliance with prudential regulations. This is another area where convergence is badly needed.

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Conclusion

Banks in emerging economies are increasingly becoming players in global banking. To maintain the stability of the global banking system it is important that these banks converge toward best practice standards and that the regulatory and supervisory infrastructure in these economies similarly meet global norms. There is an important role in this process for international standard setting, technical assistance, and monitoring compliance with these standards.

At the same time, consolidation, globalization, and the increased complexity and breadth of activities are increasing the challenge of regulating and supervising banks around the world. Best practices must therefore keep pace with market developments. I believe that a recipe for dynamic best practices involves enhancing the role of market discipline, reforming international capital standards, and improving supervisory practice.

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The Role of Private Regulation in Maintaining Global Financial Stability

Randall S. Kroszner

Many international financial transactions occur in a realm that is close to anarchy. While numerous committees and organizations attempt to coordinate domestic regulatory policies and negotiate international standards, they have no enforcement powers. The Cayman Islands and Bermuda offer not only beautiful beaches but also harbors safe from most financial regulation and international agreements. When contractual disputes arise in international financial transactions, where they would be litigated and what laws would apply are often highly uncertain.

Yet, international financial markets and institutions have grown rapidly and have performed remarkably well. The unregulated eurodollar market, to which securities issuers go to avoid domestic securities regulation, for example, has grown from nothing 30 years ago to a multitrillion dollar market without a major incident. In fact, the growth of many of the largest and most active international financial markets has been spurred by the avoidance of traditional government regulation. While frauds, mismanagement, and bankruptcies do occur—sometimes on a spectacular scale, as the collapse of BCCI and Barings illustrates—market forces have been effective regulators that have created order out of the apparent chaos of the international banking and financial markets (see Kane 1988).

The overall stability and integrity of those markets is due primarily to the role of private regulators, not public ones. To be successful in this anarchic but orderly realm, firms and markets must develop strategies that promote credibility and induce contractual performance, largely without recourse to traditional government-supplied

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Randall S. Kroszner is Associate Professor of Business Economics at the University of Chicago's Graduate School of Business. He is also a Faculty Research Fellow at the National Bureau of Economic Research.

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legal devices. Striving for competitive advantage in these markets tends to generate the private regulation that then accounts for the success of international financial markets. My emphasis in this paper will be on how innovations in strategic organizational design and governance for financial institutions can handle international regulatory challenges more effectively than traditional public regulation.

Private Strategic Responses

The private strategic responses to concerns about stability and integrity take many forms. A traditional solution had been to create a members-only club, with high standards for membership. Clearinghouses and organized exchanges are the classic examples of this approach. Long before regulators were setting minimum capital and liquidity standards, bankers were policing each others' private note issuance through privately developed clearing systems during the so-called free banking eras in 18th and 19th century Scotland and early 19th century United States through the Suffolk System in New England (see, for instance, Kroszner 1996a, 1997, and Calomiris and Kahn 1996). Since the 19th century, the clearinghouse associations of the Chicago Board of Trade and Chicago Mercantile Exchanges have been monitoring the financial health of their members and provide a form of insurance against failure of the clearing members (Kroszner 1999).

Most recent growth in the international markets, however, has been taking place outside of traditional members-only institutions. Over-the-counter derivatives trading, for example, has grown sharply during the last decade and, since 1994, has exploded. Much of the movement toward OTC markets is driven by the desire to avoid the domestic regulation that has been imposed over time on organized exchanges. Since OTC markets have no physical location, sovereign regulators have much difficulty in claiming that such activity falls within their jurisdictions.

In these effectively unregulated OTC markets, the strategic responses to the challenges of stability and integrity have taken a variety of forms. Independent credit-rating agencies play a key role in certifying the quality of potential counterparties to a transaction. These third-party monitors publicly grade the health of the major players. Contracts that involve long-term relationships often include clauses that permit early termination if a counterparty falls below a specified rating threshold. Some participants simply will not deal with others that do not meet a minimum rating. Private regulators have thus fulfilled the auditing, screening, and monitoring functions of the public regulators and have

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been quite effective even though they do not have the same legal powers to obtain information that public regulators do.

The emphasis on top ratings is a market-generated response to concerns about the risks of entering long-term contracts in the OTC derivative market. As many institutions saw their ratings slip by the early 1990s, they began to face increasing costs of participating in these markets and were excluded entirely from some transactions. Those firms then made the strategic decision to create new organizational forms to address the concerns about credit risk.

The innovation is a special-purpose vehicle, called a derivative product company (DPC), that would be structured to garner a top rating. Less-than-high-grade institutions incorporate DPC subsidiaries that have a capital and governance structure distinct from the parent. A DPC can win a triple-A rating because its capital cannot be tapped by creditors of the parent company if the parent becomes bankrupt. Also, it may have credit enhancements that do not rely upon the health of the parent. Moody's and Standard & Poor's provide flexible definitions of DPC structure to allow firms to achieve triple-A status in a variety of ways. This strategic restructuring of the firm thereby improved the long-term stability and integrity of these derivative markets, and the innovation was driven by market forces.

In addition to the rapid growth in derivatives, cross-border lending and international securities issues are at record highs. The role of banks in these activities raises another challenge for stability and integrity in the international markets—namely, the conflict of interest that can arise when underwriting and lending are combined. Consider a firm that suddenly experiences a shock that is likely to reduce its future profitability. A bank with a lending relationship to that firm may know before the market does that the firm's prospects have now dimmed. The bank's superior knowledge, however, is a double-edged sword. If the bank were free from conflicts, the bank would make an objective analysis of the firm's future and, if new securities were to be issued, reveal the information to the public. Alternatively, a rogue bank may try to take advantage of its superior knowledge by underwriting and distributing securities to an unsuspecting public and using the proceeds to repay the outstanding bank loan.

This concern was a key factor driving the passage of the 1933 Glass-Steagall Act in the United States, which forbids commercial banks from underwriting and dealing in corporate securities (Kroszner 1996b, Kroszner and Rajan 1994). The fear that such conflicts can then lead to a destabilizing loss of confidence in public securities markets continues to be a major obstacle to permitting universal banking in the United States and plays an important role in the debate over financial reform

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in transition and emerging economies. The public regulatory solution generally involves mandating complete separation or strict "Chinese Walls" between lending and underwriting operations.

Market forces, however, have been able to provide the incentives for banks to reduce the potential for conflicts voluntarily through the strategic reorganization of the firm. Banks that lack credibility are penalized in the marketplace because purchasers will pay lower prices and demand higher yields from securities underwritten by institutions they cannot trust. Prior to the Glass-Steagall Act in the United States, banks organized their investment banking operations either as an internal securities department within the bank or as a separately incorporated and capitalized affiliate with its own board of directors.

In a study with Raghuram Rajan (1997), we found that the internal departments obtained lower prices than did the separate affiliates for otherwise similar issues they underwrote. The pricing penalty associated with the internal department is consistent with investors' discounting for the greater likelihood of conflicts problems when lending and underwriting are done within the same structure. We found that the pricing benefit for the separate affiliates increased with the number of affiliate board members who were independent of the parent bank. Banks thus can enhance their underwriting credibility and performance through a strategic reorganization that separates the lending and underwriting and uses independent board members as internal monitors. Consequently, we also found that U.S. banks increasingly adopted the separate affiliate structure in the decade prior to the passage of the Glass-Steagall Act.

German universal banks, which had traditionally underwritten through internal departments, have now been moving these operations out to separate affiliates in London. Until recently, the German securities markets had been relatively uncompetitive and dominated by the banks themselves, with relatively low participation by individuals or outsiders. In those circumstances, the major players would be equally well informed so there would be little value in setting up a separate structure. To achieve credibility in an internationally competitive market, however, they have found it in their interest to separate those functions. Market competition thus propels banks voluntarily to adopt Chinese Wall structures without any regulatory requirements (see Kroszner 1998a, 1998b).

Public Regulatory Responses

Having examined the private strategic responses to promote stability and integrity in the anarchy of the international markets, let us now

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consider the roles and incentives of public regulators. Public regulators can and often do perform the same functions as private credit rating agencies by evaluating and rating the soundness of financial institutions, but the incentives of private and public regulators are quite different. The private rating agencies are rewarded for being the most effective and accurate monitor, particularly for being the first to spot a problem and warn the public about it. No one holds S&P responsible when a firm experiences a shock that lowers its credit quality. In contrast, under public regulation, distress that would trigger a downgrade is perceived as trouble not only for the institution but for the regulators as well.

To avoid taking the blame, public regulators have an incentive to delay recognizing and publicly announcing problems, since there is a chance that a positive shock could eventually resolve the distress, and waiting could allow them to put the burden on future regulators or politicians. The poor record of U.S. regulators during the 1980s giving high grades to institutions whose failures were imminent and the consistently extreme official underreporting of the bad loan problem in Japan during the 1990s illustrate this tendency. In the U.S. Savings and Loan crisis, for example, the desire to put off the day of reckoning led regulators to undertake perverse policies that obscured problems in the short run—such as permitting economically insolvent institutions to pay dividends—but were extremely costly to taxpayers in the long run (see Kroszner and Strahan 1996).

In addition, public regulators cannot be insulated from political and interest group pressures. In Chicago, the police cars are emblazoned with the phrase "we serve and protect" and often that phrase can be applied to public regulators. Rather than promote the public interest, the regulators may end up serving the private interest of the industry that they are regulating and protect it from competition (see Stigler 1988). The political pressures provide a background incentive different from that for the private regulators.

Finally, the public regulators have much greater difficulty accommodating the dynamic change of the market than do the private regulators. Moody's and S&P can provide general guidelines for good practice and then exercise their judgment as innovations occur through time. Giving public regulators wide discretion is an invitation to political and interest group pressure.

Conclusions for Regulatory Reform

The key lesson for regulatory reform is that public regulation should not be permitted to crowd out dynamic private regulation. Strategic

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organizational choices by financial institutions and third-party monitors such as credit rating agencies have been quite successful in providing stability and integrity for the international financial markets. While the market is not a perfect regulator (for example, the Caymans can provide a haven for rogues), the public regulatory alternative should not interfere with the creative experimentation and innovation that the lovely beaches of the Caymans foster.

One of the proposals from last year's G-7 summit in Denver was to increase information sharing and coordination among the public regulators. If that information is also shared with the public, applying the regulators' advice to the markets for greater transparency to themselves, then that effort is to be applauded. Some, such as Henry Kaufmann, have gone further to suggest that an international superregulator be created to set common standards worldwide. A unified international regulator is likely to slow the engine that generates the innovations that have driven the spectacular growth of the international financial markets without any clear stability advantages.

To ensure that public regulation is effective at promoting stability, such regulations should be subject to a rough cost-benefit analysis. A number of distinguished regulatory experts in different fields have recommended that such a common-sense test be applied in health, safety, and the environment (Hahn and Litan 1997). While certainly the quantification of the costs and benefits of many financial regulations is extremely difficult, the challenges would appear to be no greater than in environmental and safety areas where decisions are made about infrequent but highly costly events, much like financial crises. Emphasis on the costs and benefits of such regulation would greatly clarify the public debate and undoubtedly improve the nature of financial regulation.

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International Rescues versus Bailouts: A Historical Perspective

Michael D. Bordo

Recent events in Asia and other parts of the globe have prompted calls from many quarters for international rescue of the monetary or fiscal authorities of distressed countries, not only the current batch but also likely candidates for succor in years to come. The current debate over the experience of this decade's rescue attempts and the calls for a change in the global financial architecture to possibly redefine the roles of the present international financial institutions make the case timely for a study of international rescues from a historical perspective.

A study of the record for the past two centuries suggests that rescues before this decade were quite different from the recent series of bailouts. Prior to the 1990s, rescue loans were made in an attempt to prevent a devaluation or abandonment of a pegged exchange rate. They were temporary loans, often quite modest, offered on commercial lines usually on a reciprocal basis, and accompanied by a package of remedial policies. In many cases they were successful. In all cases the loans were repaid.

The international rescues of the 1990s mark a watershed in the purpose, size, and term of the funds provided to countries in distress. In the era before the 1990s, the purpose of international loans was to help monetary authorities preserve a pegged exchange rate, while the loans of the 1990s were made after the peg collapsed in order to bail out investors and lenders who would otherwise have suffered from a devaluation. These bailouts have been justified on the ground that they will prevent contagion—that is, stop the financial crisis from spreading to other countries. With regard to size, the large bailouts

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Michael D. Bordo is Professor of Economics and Director of the Center for Monetary and Financial History at Rutgers University. He is also a Research Associate at the National Bureau of Economic Research.

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of the 1990s reflect the growth of international capital flows to the affected countries provided by banks and nonbank financial institutions of the industrialized world. Finally, the longer term of the loans made during this decade is an indication that the troubled countries were not only illiquid but insolvent. For that reason the success of the rescues is in question.

In the remainder of this paper, I provide an overview of the history of international financial crises and rescues, discuss the lessons from that history, and consider the case for reforming the international financial architecture. Special attention will be paid to the case for making the International Monetary Fund a lender of last resort during international liquidity crises.[1]

The Historical Experience

I demarcate the rescues of the past two centuries by international monetary regime. In the period before World War II, rescue loans to central banks and sovereign governments were often arranged by or intermediated by private investment banks, such as Rothschilds, Barings, and J.P. Morgan. Since World War II, all of the rescues have been arranged by official monetary authorities, or international agencies, the IMF, Bank for International Settlements, and the World Bank.

The Gold Standard, 1821–1914

In the century before World War I, frequent short-term loans were made to central banks and other monetary authorities to relieve pressure on their reserves during financial crises. Those crises, referred to at the time as either internal or external drains, occurred as a result of real shocks—such as domestic or foreign harvest failures, wars, and indemnities—that created an adverse balance of trade. Crises also occurred during banking panics, when the public's demand for specie or expansionary action by the lender of last resort threatened the monetary authorities' reserves.

In virtually every case, rescue loans were made on commercial terms to central banks that had a record of solvency and of credible adherence to specie convertibility. The loans were regarded as a supplement to or, in some cases, as a substitute for other remedial actions designed to replenish the monetary authorities' reserves, such as raising the discount rate and credit rationing. In many cases the loans were made on a reciprocal basis. As Marc Flandreau (1997)

[1]This discussion draws on Bordo and Schwartz (1999).

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suggests, there is little evidence to suggest that these rescues were in any way systematic or part of a pattern of central bank cooperation, as has recently been maintained by Barry Eichengreen (1992).

Three episodes have resonance for today. A major banking panic in London in 1825 climaxed a business expansion of booming real activity, rising commodity prices, and speculation in Latin American stocks. Country bank credit and a highly accommodative Bank of England monetary policy, following resumption of specie payments in 1821, fueled the boom (Neal 1998, Bordo 1998). The Bank of England was late in providing liquidity to the market that would have prevented bank failures and bankruptcies. Suspension of convertibility was averted by a loan of £400,000 from the Banque de France on Monday, December 19, through the intermediation of the Rothschilds in Paris. The loan was quickly repaid.

A second episode was the failure of the House of Barings in November 1890 resulting from a debt default in Argentina, whose securities it had underwritten. The Bank of England averted a panic by arranging a "lifeboat" operation, whereby the government guaranteed loans by London banks to recapitalize Barings. The Bank's share in the rescue would have depleted its gold reserves sufficiently to threaten convertibility. In addition to raising the discount rate, the Bank protected its reserves by borrowing £2 million in gold from the Banque de France, the Rothschilds acting as intermediaries. Subsequently, it borrowed a further £1 million. The Imperial Bank of Russia also agreed to provide £1.5 million of German gold coins. British Exchequer bonds served as collateral for each of the loans. The news as much as the fact of the loans restored confidence.

After defaulting on its debt, Argentina was cut off from further British loans. Severe recession ensued. Lending resumed in the mid-1890s, after the private foreign creditors and the Argentine debtors rescheduled the debt.

The final episode was a privately arranged rescue of the U.S. Treasury in 1895. A U.S. budget deficit after 1890 and the issue of legal tender Treasury notes of 1890, redeemable in silver coin, which the Sherman Silver Purchase Act of 1890 mandated, created uncertainty about the convertibility of the U.S. dollar into gold. In January 1895, a run on gold in exchange for legal tenders reduced the Treasury's reserve to $45 million. In February 1895, the Treasury secretary contracted with the Belmont-Morgan banking syndicate to market a 4 percent bond issue and provide the Treasury with a six-month, short-term, interest-free gold credit to restore the gold reserve. During the five months after the contract was signed, no gold was withdrawn from the Treasury.

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The Interwar Years, 1919–39

The regime that was restored from 1924 to 1936 was a gold exchange standard that differed profoundly from the pre-1914 gold standard. Flaws in the structure and inappropriate policies by its members meant that whatever attempts at rescues were made when crises struck in 1931 were doomed from the start.

Austria, May–June 1931. On May 17, 1931, the Credit Anstalt, Austria's largest bank revealed that it was insolvent. The Credit Anstalt was then recapitalized by the Austrian government. A run on other Austrian banks ensued. The Austrian National Bank, as lender of last resort, engaged in discount window lending. Fears that expansionary monetary policy would reignite the hyperinflation that Austria suffered in the 1920s led to a run on the reserves of the Austrian National Bank.

The Austrian authorities tried to stem the crisis by soliciting a foreign loan from the Bank for International Settlements. The BIS arranged for a loan of 100 million schillings ($14 million) from 11 countries. The process took two weeks and almost immediately the credit was exhausted. A request for a second loan foundered when France and several other countries insisted that Austria forswear joining a customs union with Germany that had been announced in March. The Bank of England then unilaterally extended a loan of 50 million schillings ($7 million) for a week. When a rise in the discount rate proved ineffectual in defusing the speculative attack, exchange controls were imposed and Austria in effect left the gold standard.

Germany, July 1931. The crisis spread to Germany, as foreign depositors feared the Austrian events would be repeated in a country with a similar banking system and similar problems. A full-fledged banking panic occurred after the failure of the Danat Bank on July 17, 1931. The Reichsbank responded by guaranteeing its deposits. The run on other banks was ended by a suspension of cash payments. A speculative attack on the Reichsbank's reserves threatened to breach its statutory gold reserve requirements in June. The Reichsbank then sought and obtained an international loan of $100 million ($25 million each from the Bank of England, the Banque de France, the Federal Reserve Bank of New York, and the BIS) on June 25. The loan proved insufficient to stem the speculative attack. A second loan request by Hans Luther, president of the Reichsbank, for $1 billion foundered in the face of opposition by both the Banque de France and the Federal Reserve. The external drain was finally halted by the announcement of a standstill agreement on July 20 and the imposition of exchange controls.

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Great Britain, September 1931. A succession of political and economic shocks unhinged sterling's link to gold. Reserve losses starting in May 1930 brought gold reserves down to under £150 million, a level observers regarded as a critical minimum. In May 1931 the Austrian banking crisis precipitated capital flight and the announcement of a banking holiday. British deposits of £5 million in Vienna were thereby frozen. The next month banking difficulties in Germany made £70 million of German debts to British banks uncollectable, and at the same time German investors repatriated their London funds. The closing of Germany's largest bank in July and the publication of the Macmillan Committee Report led to a fall in sterling below the gold export point against major currencies. The Bank rate was raised twice in July from 2.5 percent to 4.5 percent, but it was not changed again before convertibility was suspended.

In the final week of July 1931, the Bank of England obtained matching credits of £25 million from the Banque de France and the Federal Reserve Bank of New York. The amount was inadequate to halt the run. Further loans to Britain of $200 million each from a syndicate formed by J.P. Morgan in New York and a syndicate in Paris also proved inadequate. With reserves dwindling, the government suspended convertibility on September 19.

An argument has been made that had rescue loans of sufficient magnitude been advanced and had the central bank cooperation that prevailed before 1914, or in the 1920s, been extended, the crisis of 1931 could have been prevented (Eichengreen 1992). Alternatively, had an international lender of last resort been present, it could have saved the day (Kindleberger 1989). It seems doubtful, however, that either cooperation or an international lender of last resort would have worked. The fundamental problem of worldwide deflation and depression lay with the incorrect policies followed by the United States and France, which combined with the flawed structure of the gold exchange standard inflicted depression and deflation on the central European countries with weak banking systems. Absent a reversal of the deflationary policy stance of the Federal Reserve and the Banque de France, successful rescues would have been short-lived. In the case of Great Britain, absent a major fiscal reform, no rescue no matter how large would have allowed Britain to preserve the parity.

Bretton Woods

The framers of the Bretton Woods agreement in July 1944 established an international monetary framework that would overcome the perceived problems of the interwar period, especially the perceptions

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that capital flows (hot money movements) were a key source of the instability of the 1930s and that international cooperation had failed. Embedded in the Articles of Agreement was a proscription of free capital mobility. The International Monetary Fund was established to provide temporary assistance to countries with current account imbalances. Members were to declare par values in terms of dollars and/or gold. As it evolved, currencies became convertible into dollars, with the dollar alone convertible into gold. Par values could only be altered in the event of a fundamental disequilibrium.

In addition to crises facing the members of the system, which in some respects echoed the events of the interwar experience, the Bretton Woods system was threatened by a systemic crisis. As outstanding dollar liabilities increased relative to U.S. gold reserves, so did the likelihood of a run on the center country of the system. By the late 1960s this confidence problem was worsened by expansionary U.S. monetary policy. In the face of U.S. inflation, other member countries became increasingly reluctant to accommodate growing U.S. balance of payments deficits and the system collapsed on August 15, 1971, when President Nixon closed the gold window in the face of an attempted conversion by Britain and France of dollar liabilities.

Sterling in Crisis, 1967

Sterling's experience of continuing crises and rescues presents a revealing insight into the rescue experience of the Bretton Woods regime. From 1964 internal and external objectives were on a collision course in Britain. Expansionary monetary and fiscal policies to promote employment produced inflation, a deficit in the current account, and declining international reserves. Speculation against sterling followed. The Labour Government that assumed office in October 1964 opposed devaluation, and instead adopted a surcharge on imports, leaving internal policies unchanged. In November a $4 billion IMF and G-10 loan package was arranged.

The authorities continued to maintain a relatively expansionary policy through 1965, and pressure on sterling reserves continued. In March the Bank of England drew on its swap credits with the Federal Reserve and other central banks. In May, Great Britain drew $2.4 billion from the IMF under the General Agreements to Borrow (Solomon 1982: 59).

A tight budget package was instituted in July 1965, along with restrictions on capital outflows. The pressure temporarily abated but arose anew in the spring and summer of 1966. This time a massive austerity program was instituted on July 20, and external assistance was provided by the Federal Reserve and other central banks (the

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Federal Reserve swap facility with the Bank of England was increased from $750 million to $1.4 billion).

Declining output and rising unemployment in early 1967 led to a reversal of the tight fiscal and monetary policies. The balance of payments deteriorated in the summer of 1967. A series of adverse shocks—the closing of the Suez Canal during the Six-Day War and a dock strike in October were contributing factors. A speculative attack on sterling was mounted in November. Loans of $1.7 billion from May to November were insufficient to stem the tide. Discussion of a $3 billion rescue package came to naught (Solomon 1982: 90).

The rescues of the United Kingdom and other countries during Bretton Woods occurred against a backdrop of an ongoing systemic disequilibrium that ultimately would lead to the collapse of the Bretton Woods system. Although many of the rescues were successful, in the sense that they alleviated the pressure to devalue and the loans were ultimately repaid, in the end, the adjustable peg system collapsed into the managed float regime that endures to the present. Hence, at best, the rescues were holding actions.

Post–Bretton Woods, 1973–90

The OPEC oil embargo in the 1970s dominated international events. Loans extended to low-income countries were structural and humanitarian, to enable them to buy high-priced oil. They were not rescue loans. A similar observation applies to the recycled loans by syndicated commercial banks in advanced countries, in which OPEC deposited the huge increase in its income. Those loans were extended mainly to the Latin American public sector, but the private sector also assumed a heavy burden of debt. Debt service including short-term amortization represented a claim that virtually exhausted current account income. As foreign debt continued to increase, and the ratio of public debt to GDP soared, capital flight became pronounced. Debt service by the public and private sectors came to a halt in 1982.

The strategy of national authorities in the face of this crisis was to protect the lending banks. They were cajoled to extend enough new loans to the borrowers to enable them to pay interest, and thus avoid the designation of the original loans as nonperforming on the banks' books. That strategy, also followed by the IMF, which lent enough to borrowing countries to keep up debt service, was maintained until 1987 when the banks began to provision the Latin American loans (Schwartz 1989). The solution of writing down the loans was not adopted until the end of the decade when Brady zero-coupon bonds were sold by the U.S. Treasury to the Latin American governments. This was no international rescue.

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Bailouts of the 1990s

The Mexican Crisis of 1995, the current Asian crises, and the Russian crises, unlike their predecessors, arose because of capital account, not current account, reversals. Capital flight produced the crisis in each country, beginning with a devaluation of the national currency that had fixed or crawling peg ties to the dollar or a basket of currencies.

A massive bailout of $50 billion for Mexico was arranged by the IMF and the Exchange Stabilization Fund so that it did not default on its dollar-indexed, short-term debt. Only subsequently did observers take notice of the problems of the banks with large amounts of nonperforming loans.

The Asian problems were rooted in excessive credit to the private sector fueled by international capital flows to the banks and to corporate borrowers. Credit was allocated without attention to ordinary standards of return on investment. The banks borrowed short-term in foreign-currency denominated debt and lent long-term in domestic currency. Withdrawal of foreign capital was triggered by mounting current account deficits relative to GDP. Stock market valuations plunged and overvalued currency exchange rates that were pegged to the dollar or a basket of foreign currencies depreciated as capital fled (Schwartz 1998).

The Russian economy has made unsuccessful efforts to convert a command economy into a market-oriented one. The basic command structure remains, with state enterprises, whether or not nominally privatized, operating as before. Government bonds were acquired by foreign investors, but the government has been unable to collect tax revenue sufficient to pay for its outlays. Enormous arrears of wages due government employees in state enterprises have mounted. Reform pledges have not been kept.

The Asian countries were given close to $120 billion on the ground that failure to rescue them threatened contagion not only to the immediate region but worldwide. On the same grounds Russia was given funds, but rescue has not been accomplished.

Lessons from History

Several important lessons can be learned from the foregoing historical episodes of financial crisis and rescue. Five lessons stand out in particular.

The Changing Nature of Financial Rescues

The first lesson contrasts the experience of the period before 1973 with that of subsequent decades. International lending then consti-

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tuted rescues of monetary authorities of advanced countries temporarily short of liquidity. Their difficulties were resolved with relatively small amounts of money, sufficient to stave off devaluation or abandonment of a fixed exchange rate, while remedial policies were put in place. Taxpayers' funds were not required. The recent experience of bailouts involves handing over relatively large amounts to both foreign lenders and domestic investors of emerging countries *after* devaluation of a pegged exchange rate to avoid their incurring wealth losses. These are transfers from the less wealthy to the wealthier.

A Repetition of 19th Century Events

The background to the crises of the 1990s is the opening of capital markets after 50 years of impediments to free flows enabled emerging countries to borrow vast amounts from the advanced countries (Obstfeld and Taylor 1998; Bordo, Eichengreen, and Kim 1998). The net flows today rival those of the golden age of European overseas investment before 1914, and the gross flows are a multiple of those in earlier times.

The liberalization of the capital accounts in addition to creating opportunities for growth in the emerging countries has exposed them to serious hazards. Lenders may ignore structural problems of underdevelopment in these countries and incorrect policies in their eagerness to profit from the promise of high-yielding investments. Lenders are not fully informed about internal conditions in emerging countries, and borrowers may not put the funds made available to them to their best use. In this respect the boom-bust cycle of international borrowing repeats events of the 19th century. Prominent examples include British lending to the United States in the 1830s on which a number of states defaulted, and Latin American booms followed by busts and defaults in the 1820s, 1870s, and 1890s (Marichal 1989).

The Shifting of Risk

What is different in today's boom-bust episodes compared with earlier ones is the belief that domestic financial institutions are protected by an internal safety net and that foreign lenders will not suffer losses on their loans in hard currencies because funds to compensate them will be made available by international lending agencies and the monetary authorities of the advanced countries. In earlier times losses were actually sustained by lenders, and by borrowers who were then cut off from further loans. Eventually, settlement of outstanding debts was reached, but at the cost of cessation of economic growth. Moral hazard weakens incentives for lenders to monitor the performance of both the private and public sectors where they invest. By

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contrast, in earlier times, presumably both borrowers and lenders learned the hard lesson that caution paid.

The Rise of Moral Hazard

Why has moral hazard assumed an important role in the environment of the 1990s? I offer four explanations. The first is contagion. The second is "too big to fail." The third is extension of the safety net. The fourth is an implicit contract with the IMF.

In simplest terms, the argument for the threat of contagion is that failure to bail out investors in one emerging country's markets will spill over to other emerging markets, so investors, fearful of getting burned, will abandon those markets as well. Pure contagion would occur only in circumstances in which other emerging countries were free of the problems facing the first emerging country. I know of no evidence of pure contagion. Transmission is another story. Shocks to one country will spill over to other countries through trade and the capital accounts. When investors withdraw their capital from countries with the same problems as were present in the first such country, this is a demonstration effect, not contagion.

As for "too big to fail," this is a fallacy that domestic lenders of last resort should supply liquidity to insolvent institutions because not to do so would endanger the stability of the entire financial system. The fallacy is that markets cannot distinguish between illiquid and insolvent institutions, and that normal bankruptcy procedures will not allocate resources in a timely fashion to their best use.

Extension of the safety net to cover investors' foreign holdings, such as large investment firms, presumes that the national welfare depends on their welfare. It is far from clear that protection of any sector or industry benefits the whole economy.

Finally, emerging countries may believe that they have an implicit contract with the IMF to be saved from their own folly. This is an expansion of the original terms of the Articles of Agreement at Bretton Woods that established the IMF as a social insurance fund in which members contributed resources, which would be made available to them or other members as needed. Members could have access to the fund in the event of temporary current account imbalances. Capital movements then were proscribed. Today, capital mobility has been restored, and the size of the drawings required greatly exceeds any one country's initial deposit or line of credit. Massive loans from other members at below market rates are now expected. One could argue that higher tranche IMF loans are subject to conditionality, and therefore are not free from penalty. However, in contrast to rescues of

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earlier times, where loans were offered attendant upon remedial policies, conditionality has proved to be more easily evaded.

The Failure of Pegged Exchange Rates

A pervasive problem in the case of all the crises was pegged exchange rates. In the recent examples, loans were extended by foreign commercial banks and other private lenders at interest rates that did not account for exchange risk based on the incorrect belief that adherence to the peg was durable and credible. This experience supports floating exchange rates to avoid speculative attacks on pegs (Obstfeld and Rogoff 1995). If countries maintain floating exchange rates, capital markets should be able to handle any exigencies of both private and public finance. On the other hand, in normal times small open economies may be well advised to link their national currencies to the currency of a larger trading partner. In those cases, however, when countries are faced with large foreign shocks, they have to weigh the costs of sticking to the peg against the benefits.

Reforming the International Architecture

The rescues of earlier times that were successful teach us that one should rescue a monetary authority that has a temporary liquidity problem, is adopting remedial policies, and has a good chance of timely repayment. Today's monetary authorities, including the IMF, should follow Bagehot's principles: Lend short term at a penalty rate on good collateral that exceeds the value of the loan.

One recent proposal for reform that might fit the bill is the suggestion by Charles Calomiris (1998) and Allan Meltzer (1998) that the IMF be converted into a lender of last resort on Bagehotian lines. In order for such an institution to avoid the pitfalls of moral hazard, it would need to establish tight eligibility values for members to get access to the discount window. In the Calomiris plan, for members to qualify for assistance they would have to have sound financial systems within a comprehensive framework of market-based supervision and regulation. The package includes: capital ratios based on subordinated debt, reserve requirements, secondary liquidity ratios based on foreign securities, deposit insurance, and no restrictions on entry by foreign banks. Those requirements would minimize claims on the domestic monetary authority from unsound financial institutions and the likelihood of bailouts of insolvent banks. In addition, his plan would restrict the ability of members to issue short-term sovereign debt and would require high international reserve ratios for a central bank committed to a peg.

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With those requirements satisfied, in the event of a liquidity crisis, members could borrow from the IMF on a penalty rate, on the basis of collateral of 125 percent of the loan (25 percent of which is in the form of foreign securities). The IMF would obtain the high-powered money needed to act as a lender of resort by having access to lines of credit from the monetary authorities of the G-3. Those borrowings would be fully collateralized by government securities of the country of issue. The IMF members would finance the purchase of the collateral.

Transformation of the IMF from its present structure would build upon its current functions in providing surveillance and information to the international monetary system. This plan would go a long way toward moving away from today's bailouts and the attendant moral hazard toward the true international rescues of earlier times. However, one could argue that, in today's world of open and deep capital markets, private markets could perform the same role. Hence, the need for having the IMF act as an international lender of last resort may only arise under rare circumstances.

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Creditor Panics: Causes and Remedies

Jeffrey D. Sachs

Emerging market financial crises are characterized by an abrupt and significant shift from net capital inflow to net capital outflow from one year to the next. By this standard, we find 10 cases of significant financial crisis among the middle-income developing countries in the past four years: Turkey 1994, Venezuela 1994, Argentina 1995, Mexico 1994–95, Indonesia 1997–98, Korea 1997–98, Malaysia 1997–98, Philippines 1997–98, Thailand 1997–98, and Russia 1998.[1] It is the contention of this paper that such crises typically reflect a three-stage process that hits a developing country engaged in large-scale international borrowing.[2] In the first stage, the exchange rate becomes overvalued as a result of internal or external macroeconomic events. In the second stage, the exchange rate is defended, but at the cost of a substantial drain of foreign exchange reserves held by the Central Bank. In the third stage, the depletion of reserves, usually in combination with a devaluation, triggers a panicked outflow by foreign creditors holding short-term claims.

The trigger of panic, in most cases, is the devaluation itself, resulting from the exhaustion of reserves. The panicked outflow of short-term creditors leads to macroeconomic overshooting, characterized by sharp economic downturn, typically followed by a nearly equally sharp recovery. Various dimensions of the macroeconomy are involved in this overshooting: real GDP, the real exchange rate, real interest rates, net capital flows, and stock market valuations.

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Jeffrey D. Sachs is the Galen L. Stone Professor of International Trade at Harvard University and Director of the Harvard Institute for International Development.

[1]For further details on many of these cases, see Radelet and Sachs (1998b).

[2]More detailed arguments along these lines in the case of Mexico can be found in Sachs, Tornell, and Velasco (1996a, 1996b) and in the case of East Asia in Radelet and Sachs (1998a and 1998b). Two important theoretical treatments of these crises are Chang and Velasco (1998a, 1998b), extended to an empirical discussion of East Asia in Chang and Velasco (1998c).

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Some observers, such as the editorial page of the *Wall Street Journal*, have attributed these crises to currency devaluation, since the panics have almost always followed a devaluation of the currency. As a result, those observers have generally concluded that devaluations should be avoided at all costs, since the panics have almost all followed currency devaluations. I suggest a very different point of view: that it is not the devaluation but rather the *defense* of the exchange rate preceding the crisis that has often opened the door to financial panic. In my view, the devaluation by itself is not particularly harmful, and may well be beneficial even in the short term.[3] The harm comes mainly, or perhaps entirely, from the depletion of foreign exchange reserves. The devaluation which follows the depletion of reserves usually alerts the market to the exhaustion of reserves, a state of affairs that is not fully apparent to many market participants before the devaluation takes place. When the devaluation occurs, short-term interbank credits in particular become subject to an abrupt, self-fulfilling loss of confidence. In summary, the devaluation signals the depletion of reserves; the depletion of reserves signals the inability of the central bank to act as a lender of last resort vis-à-vis foreign creditors; the short-term foreign creditors flee in panic; and the macroeconomy collapses as a result of the creditor flight. The rest of the paper describes this sequence of events and draws some policy conclusions from it.

Balance of Payments Crisis

The starting point of most emerging markets crises in recent years is a balance of payments crisis, that is, the exhaustion of foreign exchange reserves following the defense of a pegged exchange rate. In most cases, the sequence of events is as follows. First, macroeconomic shocks change the full-employment equilibrium ratio of tradeable goods prices (P_t) to nontradeable goods prices (P_n), a ratio we define as the real exchange rate R ($= P_t/P_n$). Second, the gap between the prevailing R and the R consistent with "internal balance" (i.e., with full-employment equilibrium) leads to speculation against the currency. Third, reserves are depleted in the defense of the currency. Fourth, the depletion of reserves leads to a subsequent full-blown financial panic.

[3]Even less harmful than a discrete devaluation is a gradual depreciation of the currency in response to macroeconomic shocks. Thus, Australia, Canada, Chile, and New Zealand all weathered a terms-of-trade deterioration in 1998 through a gradual and relatively uneventful depreciation of their currencies. Since their exchange rates were floating, and all four countries had ample foreign exchange reserves, the depreciation of the currency did not trigger a financial panic in any of the four cases.

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We know from standard macroeconomic theory that the real exchange rate consistent with internal balance appreciates (P_t/P_n falls) when the following events occur: (1) a terms of trade improvement; (2) a reduction of world interest rates, leading to increased net capital inflows; (3) a liberalization of the capital account that leads to capital inflows; (4) a reduction of country risk, leading to increased capital inflows; (5) fiscal expansion; (6) other positive wealth effects (e.g., a natural resource discovery); (7) liberalization of the domestic financial system that permits increased flows from savers to investors, thereby boosting domestic investment spending; and (8) a rise in investment as the result of increased confidence about future productivity. The real exchange rate consistent with internal balance depreciates (P_t/P_n rises) when the converse conditions apply.

The standard approach to real exchange rate determination is the "dependent economy model," due originally to W. E. G. Salter (1959) and Trevor Swan (1960), as shown in Figure 1.[4] The production possibility frontier PPF shows the range of tradeable and nontradeable goods that can be produced in the economy. The absorption schedule AA shows the level of domestic spending (absorption equals consumption plus investment) that falls on the two types of goods. The farther out on the AA schedule from the origin, the greater is the total domestic spending. When the economy is at point Q1, total absorption equals total production. Trade is balanced, with output and spending on tradeable goods given by the level $Q1_t$, and output and spending on nontradeable goods given by $Q1_n$. When absorption is at level 2, beyond the PPF, then the economy is running a trade deficit. Production takes place at point Q2, at which nontraded goods production and absorption is given by $Q2_n = A2_n$. Tradeable production is at point $Q2_t$, less than tradeables absorption $A2_t$. The difference, $A2_t - Q2_t$, measures the trade deficit. When absorption is at point A3, the economy is running a trade surplus. Production is at point Q3, with a trade surplus given by $Q3_t - A3_t$.

As is well known, the slope of the PPF at any point is equal to the real exchange rate, P_t/P_n. Thus, the real exchange rate is most depreciated at point Q3, and most appreciated at point Q2. The real exchange rate at point Q1 is in between these two cases. The key point is the following. For a given PPF, a rise of absorption leads to a real exchange rate appreciation. In essence, the rise of demand provokes an increase in spending on both tradeables and nontradeables. At a given real exchange rate, this leads to an excess demand for nontradeable goods, which in turn causes a rise in the relative

[4]A summary of this model may be found in Larrain and Sachs (1993: chap. 21).

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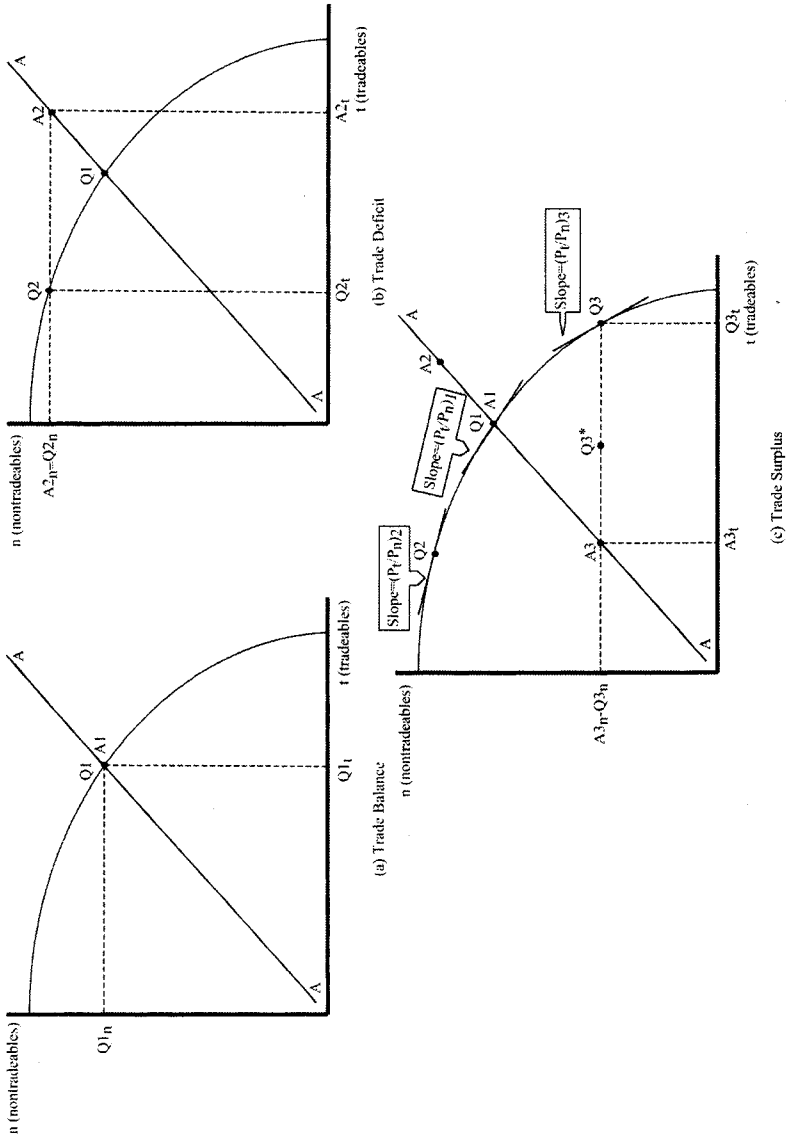
FIGURE 1

PRODUCTION, ABSORPTION, AND THE REAL EXCHANGE RATE



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price of nontradeables—that is, a real appreciation. (The increased demand for tradeables is met by net imports, rather than by increased domestic production). Contrariwise, a fall of absorption requires a real depreciation, as the cutback of spending on nontradeables leads to a reduction of the relative price of nontradeables.

A rise in absorption, leading to a real appreciation, can arise in many macroeconomic contexts, as noted previously. In the typical case in Latin America, real appreciation has occurred in the aftermath of stabilization from high inflation. In the typical case in East Asia, real appreciation resulted from capital market liberalization. Consider first the "Latin American case" of ending high inflation. At the beginning of successful stabilization programs, P_t/P_n tends to decline. This occurs for several reasons. First, domestic investment spending recovers at the prospect of improved domestic productivity. The stabilization may also lead to a consumption boom, as a result of the elimination of the inflation tax (this occurred strongly in Argentina and Brazil). The banking sector becomes remonetized, often through the repatriation of flight capital. This remonetization restarts domestic bank lending. Additionally, the stabilization may trigger a reduction in the risk premium on international lending to the country, thereby increasing net capital inflows. In the "East Asian case," capital account liberalization (which occurred in the early 1990s in Thailand, Korea, the Philippines, and to an extent in Malaysia) led to a rise in absorption and a real appreciation. The opening of the domestic banking sector to international borrowing caused domestic real interest rates to fall and provoked a large inflow of lending from abroad, thus financing a substantial increase in investment spending as a percent of GDP.

In both Latin America and East Asia, the policy changes also included liberalization of the domestic banking system (e.g., a reduction of reserve requirements, an end of interest rate ceilings, and a liberalization of entry into the banking system). These changes also contributed to a rise in domestic absorption.

The boom in domestic absorption is typically transitory: the rapid rebuilding of the capital stock following a stabilization tends to be completed in a few years; the boom in net capital inflows abates; the remonetization of domestic banking systems is completed within a couple of years; and the initial consumption boom tapers off. *As a result, the pressures that lead to the initial real exchange rate appreciation at least partly reverse themselves, leading to pressures for real depreciation.* In a gradual (an optimal) adjustment, we might expect absorption to rise and then to decline gradually. In practice, a financial panic may drive the economy from A2 to A3, with harrowing consequences.

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This pattern of appreciation followed by market pressures for real depreciation seems to have been the pattern in Argentina, Brazil, and Mexico, as well as in the developing countries of East Asia. Latin American stabilization was followed by an initial real appreciation, consistent with increased domestic spending and capital inflows. After a few years, however, the spending boom and capital inflows tended to abate, putting downward pressure on the real exchange rate. In East Asia, foreign lending began to abate by the end of 1996 in several countries as the huge inflows of capital financed an investment boom—and incipient overcapacity—by the end of 1996.

As is well known, necessary adjustments to the real exchange rate can be met either by price movements or by nominal exchange rate movements, depending on the exchange rate regime. The traded goods price is given by $P_t = EP_t^*$, where E is the nominal exchange rate (in units of domestic currency per unit of foreign exchange) and P_t^* is the world (dollar) price of tradeable goods. The real exchange rate is then $R = EP_t^*/P_n$. An appreciation can be brought about through either a nominal appreciation (E falls) or a rise in the price of nontradeable goods. A depreciation can be brought about through either a nominal depreciation (E rises) or a fall in the price of nontradeable goods.

Experience teaches that an absolute decline in P_n is difficult to achieve in a short period of time. When the extent of needed real depreciation is large, therefore, financial markets tend to expect that policymakers will support the relative price change through devaluation (or market-driven depreciation) of the nominal exchange rate rather than by internal price deflation (i.e., the decline in P_n). Therefore, when P_t/P_n is low relative to the market's estimate of the value consistent with full employment, there will almost inevitably be widespread expectations of a nominal exchange rate devaluation (or depreciation, if the currency is simply allowed to float).

Widespread expectations of depreciation can be difficult to resist, since in almost any economy, currency in circulation plus bank money (M2) is considerably higher than foreign exchange reserves. This is the case even when foreign exchange reserves are sufficient to cover high-powered money (notes in circulation plus commercial banks' reserves at the central bank), as is the case of currency board arrangements. Suppose that M2 holders begin to convert their money into foreign exchange in expectation of devaluation, and suppose that the central bank defends the exchange rate, by buying high-powered money and selling dollars. Suppose that the money multiplier is mm (= M2/Mh), greater than 1. In principle, each unit of high-powered money withdrawn from the banking sector and converted into foreign

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exchange results in the reduction of M2 equal to 1/mm. In principle, the central bank only needs foreign exchange reserves greater than or equal to Mh, rather than M2, in order to be able to stave off a successful attack on the exchange rate, since the reduction of Mh will lead to a multiplied reduction of M2.

This assumes, however, that the central bank will force the banking sector to shrink outstanding loans by a *multiple* of the initial withdrawal of funds. In practice, such a contraction of loans quickly leads to illiquidity of the banks, and therefore to an incipient bank panic. In short, money multiplication (in which a unit increase of Mh leads to mm units of increase of M2) is not quickly reversible, since the bank loans are tied up in nonliquid assets that cannot immediately be called in by the banks. The result is that the central bank must provide liquidity to the banking system when net withdrawals are made from the banking system. As a result, if money holders begin to convert M2 into foreign exchange, the central bank will need reserves nearly equal to M2, rather than merely Mh, in order to be able to defend the currency. Very few central banks have sufficient reserves to cover a wholesale withdrawal of funds from the banking sector. (To hold such a high level of reserves would also involve large opportunity costs, since reserves typically earn less than alternative investment opportunities available to the economy).

The main implication is that a concerted attack on the currency, one that involves—or could precipitate—a massive withdrawal of bank money, *is likely to succeed*, no matter what the resolve of the central bank. Markets understand this. Most currency pegs are therefore vulnerable to attack when the underlying real exchange rate is clearly overvalued relative to the level consistent with internal balance. Even if the government tries, through a heroic credit squeeze and sky-high interest rates (which reached overnight rates of 500 percent per annum during Sweden's ill-fated defense of its currency in 1992), the banking sector can easily crack before the defense establishes credibility. There are exceptions, no doubt. Perhaps Argentina and Hong Kong will prove to have a more credible peg, as a result of the institutional arrangements of the currency board system. Both economies have demonstrated the willingness to "walk through fire" to defend the peg; and both countries have implicit external backers of the currency regime (the United States and IMF in the case of Argentina; China in the case of Hong Kong). In any event, time will tell.

Creditor Panic

The essence of recent emerging markets crises is that the exchange rate defense, typically ending in a devaluation, has often been followed

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by a rapid and ferocious withdrawal of credits by foreign investors. Thus, a current account deficit is not resolved by a return to current account balance but by a virulent swing of the current account into surplus. The crucial point is that it is financial market *panic*, not currency devaluation, which leads to the abrupt swing of the current account from deficit to surplus, and to acute damage to the emerging market and to the creditors.

In emerging markets, the domestic economy (including banks, non-financial enterprises, and government) is heavily indebted to foreign investors, including international banks, hedge funds, and other investment funds. Much of this debt is short-term (i.e., with maturity under one year), partly as a result of BIS regulations on capital adequacy that encourage short-term rather than long-term lending. Additionally, much of the debt has trigger clauses, such that repayment is immediately accelerated in the event of a contractual default by the debtor to *other* creditors (cross-default clauses). The borrowing, in general, has been converted into long-term, relatively illiquid investments. As a result, total short-term debt is often significantly greater than the available short-term assets that might be mobilized to repay creditors in the event of a withdrawal of new lending. As a rough measure, one could compare a country's short-term debts to international banks with the foreign exchange reserves held at the central bank, shown in Table 1. Steve Radelet and I found that when a nation's ratio of debt to reserves is greater than 1, that country has proven to be particularly vulnerable to a creditor panic (Radelet and Sachs 1998b).

The central bank's foreign exchange reserves are crucial since the central bank is widely, and rightly, understood to be the lender of last resort not only to the banks, but to the government and corporate sector as well, in the event of an external creditor panic. Suppose that foreign banks begin to withdraw credit lines from domestic banks, demanding repayment of outstanding loans. This immediately leads to financial distress in the banking system, since the banks have transformed the foreign loans into long-term investments. The bank may, to some extent, use liquid domestic assets to purchase dollars in the foreign exchange market, but even so, the bank is unlikely to have sufficient liquid assets on hand to meet a large-scale withdrawal of funds. Thus, the central bank will almost surely have to extend credit, either directly as foreign exchange loans, or as domestic credit which is then sold in the foreign exchange market. In the latter case, of course, the exchange rate will depreciate in the absence of official intervention.

Once foreign exchange reserves have been depleted, the central bank's lender-of-last-resort functions are deeply compromised, and

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TABLE 1

SHORT-TERM DEBT AND RESERVES: SELECTED DEVELOPING COUNTRIES, 1994 AND 1997
(Millions of Dollars)

	June 1994			June 1997		
Country	Short-Term Debt	Reserves	Ratio: Debt-to-Reserves	Short-Term Debt	Reserves	Ratio: Debt-to-Reserves
Argentina	17,557	13,247	1.325	23,891	19,740	1.210
Brazil	28,976	41,292	0.702	44,223	55,849	0.792
Chile	5,447	10,766	0.506	7,615	17,017	0.447
Colombia	3,976	7,718	0.515	6,698	9,940	0.674
India	5,062	16,725	0.303	7,745	25,702	0.301
Indonesia	18,822	10,915	1.724	34,661	20,336	1.704
Jordan	647	1,291	0.501	582	1,624	0.358
Korea	35,204	21,685	1.623	70,612	34,070	2.073
Malaysia	8,203	32,608	0.252	16,268	26,588	0.612
Mexico	28,404	16,509	1.721	28,226	23,775	1.187
Pakistan	1,708	2,307	0.740	3,047	1,249	2.440
Peru	2,157	5,611	0.384	5,368	10,665	0.503
Philippines	2,646	6,527	0.405	8,293	9,781	0.848
South Africa	7,108	1,755	4.050	13,247	4,241	3.124
Sri Lanka	511	1,983	0.258	414	1,770	0.234
Taiwan	17,023	90,143	0.189	21,966	90,025	0.244
Thailand	27,151	27,375	0.992	45,567	31,361	1.453
Turkey	8,821	4,279	2.061	13,067	16,055	0.814
Venezuela	4,382	5,422	0.808	3,629	13,215	0.275
Zimbabwe	704	534	1.319	731	447	1.635

SOURCE: Radelet and Sachs (1998b: 15).

understood to be so. Even if the central bank extends domestic credit (of which there is no limit), the exchange market implications are likely to be dire in the event of a large, synchronized withdrawal of creditor claims. Indeed, such withdrawals will almost surely provoke not only a collapse of the exchange rate but a suspension of debt payments if foreign exchange reserves are depleted and the stock of short-term debts being withdrawn is large relative to trade flows.

In those circumstances (a depletion of foreign exchange reserves and a high level of short-term debt), the economy becomes vulnerable to a self-fulfilling run. Even if fundamentals are adequate to ensure long-term debt servicing without default, they are not adequate to guarantee short-run debt servicing in the event of a panic. Thus, a panic can unfold simply by the belief of creditors that it will indeed occur. In the past several years, such panics have been triggered mainly by three types of events: (1) the sudden discovery that reserves are less than previously believed; (2) unexpected devaluation (often in part for its role in signaling the depletion of reserves); and (3) contagion from neighboring countries, in a situation of perceived vulnerability (low reserves, high short-term debt, and an overvalued currency).

It is interesting and important to stress that currency devaluation, following a long defense of the exchange rate, has typically been the most important trigger of subsequent panic. This seems to be the result of several factors. First, many investors have been caught off guard by the devaluation even when it has been widely discussed. These investors seem, incredibly enough, to have taken at face value the solemn commitments of governments not to devalue. Second, the devaluations are often the signal that foreign reserves are lower than publicly announced up to that point. In Mexico in 1994, the late-December devaluation "revealed" the steep loss of reserves in early December 1994. In Thailand, the July 2, 1997, devaluation was followed by public announcements that the Thai central bank had a large book of forward dollar sales. Those dollar sales were not previously announced, and came as a large jolt to the market. In Korea, the December 1997 devaluation was the occasion for revealing that much of the central bank's announced foreign reserves were actually illiquid claims on Korean banks, the result of preceding unannounced deposits of the reserves in offshore Korean banks experiencing a run on interbank loans (in effect, the central bank had been making unannounced extensions of credit to offshore Korean banks). Speaking in the most general terms, the collapses of pegged exchange rate regimes have also been viewed as improper "breaches of faith" with foreign

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investors, despite the fact that such devaluations were almost always the result of *force majeure* (i.e., the depletion of foreign reserves.)

When the panic gains full force, the effects are devastating. The rational behavior of each short-term creditor is to demand repayment as rapidly as contractually possible and to suspend routine interbank lines that support letters of credit and other standard trade financing operations. Long-term fundamentals cease to play any role in investor thinking, since the logic of *sauve qui peut* dominates in a creditor scramble in which creditors are serviced on a first-come, first-served basis. The macroeconomic results are a huge overshooting: (1) debt is drawn down even when domestic investments (e.g., in working capital and letters of credit) have a rate of return vastly greater than the world cost of capital; (2) the real exchange rate depreciates sharply, far overshooting any real correction that needs to be made; (3) the current account swings wildly from deficit to outright surplus; (4) the banking system suffers illiquidity, and perhaps an ancillary panic by domestic savers; (5) market real interest rates soar to astronomical levels, as each borrower scrambles to mobilize funds to avoid default; and (6) partial default on foreign exchange obligations becomes almost assured. The key effects on macroeconomic contraction are the collapse of bank lending, leading to a collapse of trade and production, and the conversion of illiquidity into insolvency over the course of a few months, as loans become nonperforming—under the weight of reduced production and sales and the crushingly high interest rates on working capital.

The implications of a bank panic may be represented in a stylized way using the two-sector diagram. The abrupt withdrawal of credits forces the economy, dramatically, from A2 to A3. In the full-employment model, this causes production to shift from Q2 to Q3, with an attendant large depreciation of the real exchange rate. In practice, the accompanying financial distress forces the economy far inside the production possibility frontier, to a point like Q3*. Both tradeable and nontradeable production are much less than is consistent with full-employment equilibrium, since firms can not get working capital to maintain production at feasible levels.

Further Discussion of the Links of Balance of Payments Crisis and Creditor Panic

So far, I have told the story in a linear way: from overvalued exchange rate to balance of payments crisis to foreign creditor panic. This sequencing seems to represent an appropriate stylized description of recent crises. In theory, the linkages of balance of payments crises

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and creditor panics can be considerably more complicated. The sequence of papers by Chang and Velasco (1998a, 1998b, 1998c) provide the clearest discussion of these issues yet available.

A complete theoretical account must recognize several distinct kinds of financial fragility. Panics can involve several types of motivations: fear of country-level illiquidity (total liquid foreign exchange liabilities exceed total liquid foreign exchange assets in the country); fear of banking collapse (total liquid liabilities of banks exceed total liquid assets); fear of exchange rate depreciation (expectations, perhaps self-fulfilling, of a capital loss on domestic-currency assets). Each of these fears can lead to a self-fulfilling outcome.[5] Moreover, these concerns can interact in complex ways. I have argued that fears of a devaluation can lead to the conversion of domestic money into foreign money, thereby draining foreign reserves and opening the country to a creditor panic. Alternatively, the panic may start simply as a bank run, in which either foreign or domestic bank creditors, or both, withdraw their claims on the banks out of fear of banking-sector illiquidity. In that case, a financial panic can occur even without an overvalued currency. The central bank cannot save the banking system if the banks' foreign exchange liabilities exceed the foreign reserves available to the central bank (plus the liquid foreign exchange reserves held by the commercial banks).

In short, there are many paths to financial crisis. The one described in this paper, from overvalued currency to loss of reserves to creditor panic, is just one possibility. A plain-vanilla banking panic is another. Distinguishing among types of financial crises involves not only theoretical questions but empirical questions of considerable subtlety.

Policy Implications and Outstanding Issues

The main policy issues are: (1) how to prevent a balance of payments crisis that leads to a creditor panic; and (2) how to respond to a crisis that in fact occurs. On the first point, the logic of these crises points to three principal policies. *First, flexible exchange rates dominate pegged exchange rates in almost all cases*, since the central bank does not need to squander foreign reserves in a defense of an overvalued currency. Even the successful peggers, Argentina and Hong Kong, do not escape the implications of creditor panic. Argentina suffered a decline of 7 percent of GDP in 1995 in the wake of creditor panic. Hong Kong experienced an unprecedented decline of around 4 per-

[5]Specifically, there are multiple equilibria. If the fear becomes widespread, the feared outcome occurs, while if the fear is not widespread, then the outcome does not occur.

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cent of GDP in 1998. *Second, short-term borrowing by domestic banks and government should be limited as a matter of prudential policy*. There is simply no excuse for allowing a high level of maturity transformation of foreign short-term loans into domestic investments. Limits on short-term borrowing by banks should fall under the heading of prudential standards rather than capital controls. And yes, foreign loans should be treated differently from domestic loans, since the ability of the central bank to be a lender of last resort on foreign borrowing is inherently limited. *Third, domestic banking regulation in the form of enhanced capital adequacy standards, and policies that encourage partial banking-sector ownership by foreign capital, take on special importance as ways of limiting vulnerability to foreign creditor panics.*

With regard to policies in reaction to creditor panics, it is clear that the IMF has failed to function as a true lender of last resort, and probably inherently so. The IMF loans are much too small to cover potential outflows and therefore have done little to stop creditor panics. Indeed, provocative IMF actions have probably contributed to the panics. Moreover, the IMF's expertise, political legitimacy, and power within debtor countries is too limited to justify greatly expanded lending programs. More generous IMF lending under such conditions would most likely exacerbate well-known and much debated problems of moral hazard and distributional inequities of current programs.

Remedies to creditor panic will therefore almost surely have to involve ways to improve the collective response of creditors to panic-prone situations, as in domestic bankruptcy law. This means finding mechanisms to achieve: (1) creditor standstills in the event of extreme financial distress hitting a national economy; (2) methods for raising fresh working capital in the midst of a creditor squeeze (analogous to debtor-in-possession financing under the bankruptcy law); and (3) methods for creditor-debtor bargains for stretching out loans, converting debts to equity, and writing down claims, in the event that a panic is followed by a solvency crisis.

There are many outstanding issues—both theoretical and empirical—that bear much greater analysis.

- Are creditor panics the result of perceived insolvency of the debtor institutions rather than mere illiquidity (as asserted in this paper)?
- Who are the creditors that actually pull the plug: international commercial banks, as seems to be the case on published data; international hedge funds and other nonbank financial institutions; domestic savers?

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- To what extent do devaluations lead to financial crisis by signalling the depletion of foreign exchange reserves, or by provoking balance-sheet crises due to mismatches in assets and liabilities?
- What are the economic forces that lead to currency overvaluation, and can these be resolved through domestic deflation as well as nominal currency adjustments?

These and other questions need to be addressed if we are to improve the global financial architecture.

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Lessons from the Asian Financial Crisis

Y. C. Richard Wong

The Asian Miracle Is Alive

The Asian financial crisis may have finally put to rest the myth that the region's success has come about as a result of a unique system of capitalism rooted in Asian values—a system immune to the depressions and other troubles that economies in the West have to endure. Now, however, this claim is being replaced with a skepticism that is equally wrongheaded: a perception that the so-called Asian miracle had no substance, that it was a house of cards destined to collapse under the weight of cronyism and corruption.

The fact remains that real per capita incomes in the Asian economies have grown at an average rate of 4 to 6 percent per annum since the 1960s. This is not some national income accounting anomaly but, rather, a reflection of the high and rising rates of consumption that anyone who has lived or traveled in the region can easily observe. It is also reflected in the vast improvements in health, life expectancy, and education of the Asian people. Even if the present crisis stopped all economic growth for the next five years, these economies would have performed well above the world average for some three decades.

Asia's success has not been built on the discovery of a new form of capitalism, advocated by Singapore's Lee Kuan Yew and Malaysia's Mahathir Mohamad and promoted quietly by Japan's faceless bureaucrats. Rather, its success has been due to a tried and true formula, the vital ingredients of which include a hard-working, well-educated and trained labor force, and a vigorous entrepreneurial class that invests in plants and equipment. Asian nations spend more on human capital than do the vast majority of nations with comparable levels of per capita income and appreciate the importance of the market economy. They have promoted economic freedom by lowering taxes and

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Y. C. Richard Wong is Director of the Hong Kong Centre for Economic Research and Director of the School of Business at the University of Hong Kong.

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reducing barriers and restrictions in markets for goods and services and in labor and capital. Moreover, the physical infrastructure—the highways, office towers, and factories that these countries built at breakneck pace—is still in place. None of these vital ingredients have been fundamentally altered as a consequence of the Asian crisis.

What Went Wrong?

The issue of what went wrong can be usefully examined from a historical perspective. If we take into account the historical development of the Asian crisis, we will be more likely to succeed at any future attempts to build new institutions and reshape the global financial system.

The causes of Asia's crisis were quietly developing as far back as the late 1980s. Many factors played a role in its unfolding:

- Banks in Japan and Europe were glad to lend overseas because of the economic recession at home and were also tempted by the high profit margins of Southeast Asia.
- The long-standing economic boom and low interest rates in the U.S. markets released a torrent of funds seeking higher yields in emerging markets.
- The emergence of China as a major exporting nation in the region contributed to the worsening current account balance of some Southeast Asian economies.
- The confidence of many Asian leaders eager to push their development plans without regard for economic fundamentals and to grow instant international financial centers by liberalizing financial markets prematurely, often supported by a chorus of international agencies, bankers, and investors.
- Corrupt practices, outdated banking rules, and weak supervision left many Asian nations totally unprepared to handle a flood of foreign funds in a global capital market.

The overwhelming confidence of some Asian leaders and central bankers in their ability to successfully defend their currencies against speculative attacks finally led to total collapse and bankruptcy.

The 1987 Plaza Accord brought down the value of the U.S. dollar and ushered in a new era of the appreciating Yen. This led to a six-year cycle of Japanese investment in Asia that transformed and expanded the industrial base for Malaysia, Indonesia, and Thailand. Japanese capital outflows reflected that nation's domestic problems. Japan's leaders refused to write off mounting bad debts in the banking system after the asset bubble burst. Japan pursued a low interest rate

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policy to keep the banks solvent. The banks in turn took unusual risks by lending to many Asian economies in search of high yields in a bid to resolve their own domestic debt problems.

Foreign banks and other institutional investors from Europe and later the United States, all flush with funds, soon discovered Asia's emerging markets, where interest rates were high and risk was very low because currencies were pegged to the U.S. dollar. This environment led to a five-year boom in Asian equities. As the Asian economies grew, infrastructure bottlenecks became apparent. The World Bank's high-profile claim that Asia needs $1 trillion worth of investment in infrastructure and bond markets soon captured the public's imagination. Japanese, European, and to a lesser extent U.S. banks were soon providing short-term foreign currency loans at low interest rates to finance long-term infrastructure and real estate projects in Malaysia, Indonesia, and Thailand. In Korea, the same short-term loans were used to support investments in projects favored by government industrial policy.

In addition to effecting currency and maturity mismatches, these banks often extended loans without adequately assessing credit risks. Indeed, the current obsession with the lack of transparency and the accusation of Asian crony capitalism were hardly mentioned then, as foreign investors and lenders ingratiated themselves with the powerful and influential and envied each other for their special and privileged access to the power elite. The lack of transparency in Asian business transactions that is much lamented today was viewed then as an opportunity for making huge profits that warranted taking large risks. These stories were well known among bankers, and they are now finding their way to the press as accounts of failures surface.

By 1995, the era of the strong yen was being replaced by the era of the strong U.S. dollar, and a number of Asian economies were slowing down and experiencing current account deficits. Nevertheless, capital inflows continued to accelerate. Thailand was the country whose exports were most obviously affected by China's entry into the world market, but South Korea, the Philippines, Indonesia, and Malaysia were all slowing down for a variety of different reasons. China was trying to engineer a soft landing after earlier excesses had led to intolerably high inflation rates. Hong Kong also experienced a slowdown as the government acted to restrain the credit growth that had occurred as a result of rising asset prices.

At the end of the day, Asian economies became vulnerable as markets became increasingly aware of the excesses that had been built up as a result of the poor investment decisions that had been made in an attempt to employ the huge increases in portfolios for investment.

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In some cases, excesses were fed by unsound real estate and other lending activity that undermined the soundness of the financial systems of the affected Asian economies. These excesses were reflected in overvalued exchange rates, growing current account deficits, and highly inflated asset values.

The excesses of Asian governments, financial institutions, and nonfinancial firms would not have been possible without the availability of cheap credit. The international banks and other foreign lenders made it possible for these excesses to take on disastrous proportions. The availability of cheap foreign currency-denominated credit that was extended almost indiscriminately set the stage for the Asian crisis. Foreign lenders were no doubt encouraged by the willingness or perceived willingness of international agencies and the U.S. government to bail out bankrupt countries, as they had in the case of Latin America in the 1980s and Mexico in 1994–95. There is little doubt that the actions of the International Monetary Fund in bailing out countries had created a serious moral hazard problem in international lending.

The moral hazard problem in international lending is a serious one that has to be properly addressed in any future design of the global financial system. Greater transparency and better surveillance systems are necessary, but the effectiveness and value of those changes are difficult to assess. The outcome would depend on how the new information is used and, hence, on the incentives confronting decisionmakers.

A novel suggestion proposed by Charles Calomiris (1998) to invite banks to police each other is worth serious consideration, especially if it could be implemented. Part of the solution would be to reduce our dependence on banks as suppliers of capital to industry, partly by shrinking the banking industry itself, but, even more importantly, by steadily expanding the number and variety of market alternatives to bank loans. Here, as so often in economic life, we must rely on decentralization and diversification—in this case, diversification of financing alternatives—and not on the presumed superior judgments of large banks and their regulators for directing capital to its most productive uses.

Unlike their Latin American counterparts, Asian entrepreneurs generally trusted their governments to enact sound economic policies. Although that trust may have been misplaced, it was genuine. Against such a background, advocates of Asian values found a willing audience. But their failure to sense the dangers of borrowing short in foreign currency and investing in long-term projects with earnings denominated in local currency was disastrous. The World Bank's 1993 study,

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The East Asian Miracle, also failed to recognize the danger inherent in the attempt of governments to achieve national and developmental goals by domination of credit markets. The ambitions of Asia's political leaders in the newly emerging market economies were seldom challenged.

The excessive confidence of Asian leaders and central bankers blinded them to the severity of the economic and financial problems that were emerging. During the Mexican crisis, speculators attacked a number of Asian currencies, which alerted governments to the dangers inherent in short-term capital outflows. It also led Asian leaders to view such speculative activity as purely opportunistic and unjustified by economic fundamentals. How could speculators justify attacking Asian currencies? Actually, the real problem was halfway around the world in Mexico, an economy whose ties to Asia are very limited.

This episode nevertheless prompted most Asian central bankers to devise "repo agreements" to defend their currencies against speculative attacks. Hong Kong authorities had another reason to be concerned about the prospect of a speculative attack against the Hong Kong dollar—namely, the handover of the territory in 1997 to China. They were determined to maintain the rigid link to the U.S. dollar.

This mindset was first put to the test in Thailand. The Bank of Thailand fought back hard against the speculators, but eventually it ran out of foreign reserves and devalued the baht in July 1997. Once the peg to the U.S. dollar was abandoned, the baht lost more than 50 percent of its value. The Bank of Thailand's first mistake was to try to fight off the speculators by raising interest rates and tightening market liquidity. Raising interest rates did little to discourage the speculators, and ended up actually enriching those who had sold the baht short in the forward exchange market. The higher interest rates also inflicted terrible damage on the Thai people, many of whom were borrowing short and lending long.

The most damaging mistake, however, was the Bank of Thailand's attempt to conceal the true state of its foreign exchange holdings. The bank deceived the public and foreign investors by overstating the amount of foreign reserves it had for fighting off speculators and maintaining the value of the baht.

When the bank finally admitted that its foreign reserves were mostly gone, there was a massive run against the baht, which quickly swamped the additional liquidity that the IMF had brought in and changed the terms of the battle from one of countering speculators to one of stemming widespread capital flight by the Thai people themselves. With the deception by even the trusted Bank of Thailand revealed, the remaining Thai institutions, financial and political, could not with-

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stand the loss of confidence. What might otherwise have been a minor realignment of 10 or 15 percent turned into a major disaster.

The speculators were probably encouraged by the willingness of Asian nations to support their currencies, despite the vulnerabilities of their economies and their ineptitude at defending themselves successfully against such attacks. With the baht down so dramatically, the speculative attack quickly spread to Thailand's neighbors and competitors—Malaysia, Indonesia, the Philippines, and South Korea. Singapore and Taiwan were also affected, but their currencies suffered only minor devaluations. Hong Kong was able to avoid devaluation altogether, largely because of its currency board system, the relative transparency of its monetary and banking system, and the fact that the people of Hong Kong did not lose confidence in their government and its promise to maintain the value of the currency.

I am not convinced that the rapid spread of these events throughout Asia is the result of some contagion effect. The fact that they happened more or less simultaneously can be attributed to the fact that many of these economies are remarkably similar in the fundamental nature of their problems and became vulnerable at around the same time. Their plights were to a large extent the culmination of the same global market forces that had been in operation for about a decade before the crisis emerged. Moreover, their responses to speculative attacks were very similar, even though the final outcomes varied depending on the relative strength and soundness of their monetary and financial systems.

The Asian economies were due for a major adjustment after a decade of rapid and excessive growth. But the total collapse of the monetary and financial systems in some of these countries was unnecessary and could have been avoided if better policies had been adopted to manage the speculative attacks on the currency. The implementation of such policies would have been followed by a period of painful adjustment, but the current plight of the economies in Thailand, South Korea, and especially Indonesia could have been avoided as a result.

The IMF's attempt to help these economies was largely unproductive. While the evidence is not yet conclusive, there is a growing suspicion that the IMF acted as the unwitting handmaiden to broker a bailout of lenders and a bailin of borrowers at the expense of the public. The bailout package the IMF put together was too little, too late. And its effort was focused initially on austerity measures that pushed the economies into depression when the most immediate issue at stake was a collapse of the credit system that had adversely affected many otherwise sound companies. To be fair, it is not evident that, on this most urgent issue, there was much the IMF could have done

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quickly, given its own limitations to perform the role of international lender of last resort.

Should an international lender of last resort be created to deal with a crisis situation after it has happened? That question is receiving substantial attention. The purpose of such a facility would be to lend freely, to banks that are distressed but solvent, against collateral, and at a penalty rate of interest. That arrangement would let insolvent banks fail but help sound banks facing a temporary liquidity crisis. In practice, however, the moral hazard problem is unlikely to be easily or fully mitigated, and any lender of last resort flush with funds is likely to invent a new role for itself from time to time.

Recovery and Lessons

As I mentioned at the outset, none of the vital ingredients of the success of the Asian miracle have been fundamentally altered as a consequence of the Asian crisis. Moreover, if there is anything remaining of the term "Asian values" that still applies to the population there today, it is their untainted record of relying on self-help, hard work, and entrepreneurship. Before long those positive attributes will renew the Asian miracle.

A new era of prosperity is possible as these nations rebuild their banking and financial systems. We may even have reason to hope that some of the flaws in their economic and political systems, and the much too cozy relationship between government and business conglomerates, will be corrected, creating more open and transparent systems. Such institutional reforms would encourage new business activity and attract an inflow of capital from abroad.

The Asian crisis has once again revealed that currency crises are a result of the compromise between monetary unification (the only true fixed-rate regime) and a freely floating exchange rate. The performance of Hong Kong's currency board system, despite its flaws, has presented itself as a viable option for many open economies. There is much to be said for its transparency, its single-minded policy objective, and its discipline on domestic macroeconomic policies. Indeed, a further step toward monetary unification would be to dollarize the economy—that is, eliminate the Hong Kong dollar and replace it with the U.S. dollar. Dollarization would remove any doubt about the possibility of either devaluation or revaluation.

The Asian crisis no doubt will lead to a growing demand for capital controls, transaction taxes, or other market-inhibiting initiatives to limit international capital flows. Such policies would have large and adverse unintended consequences. In a global system, suppressed

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markets in one area would be rapidly displaced by others outside the reach of government controls and taxes. Furthermore, risk-taking would be curbed, to the detriment of rising living standards.

It is worth noting that the global financial system is not an end in itself, but an institutional structure that has responded to and facilitated the production and distribution of goods and services. There are bound to be incongruities between the institutional requirements of a global financial system and the prevailing institutions in an emerging market. This is part of the problem some Asian economies faced when they began to partly liberalize their financial systems. They each lost sight of the purpose and objectives of financial liberalization and became enamored with the ambition and grandiosity of developing an international financial center for their own country.

The Asian financial crisis may well be a blessing in disguise for the region. It has provided an opportunity to review things in a fundamental way. And, intellectually, it has put to rest the idea that there are new laws of economic growth that have been uncovered by the Asian miracle.

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Asia: The Fall of a Second Berlin Wall

José Piñera

The fallout from the current Asian financial crisis has led some people to believe that there was no Asian take-off. Yet, even after the sharp recession, GDP per capita at the end of 1998 was four times that of 1960 in Japan and the Four Tigers (Singapore, South Korea, Taiwan, and Hong Kong). Asia's extraordinary economic growth was not a miracle in the sense that something mysterious or out of this world generated it. It was, on the contrary, the result of introducing, in countries whose potential GDP was much higher than their actual GDP, some degree of market freedom. The crisis should not cause us to forget decades of very fast growth that had the Asian Tigers on the verge of abandoning the Third World.

But there was a fatal flaw in the process, and the day of reckoning has arrived. That was the notion that there is a "Third Way" between democratic capitalism and socialist statism. That dangerous and erroneous idea bred the structural problems that erupted in the current crisis. In this case, the Third-Way notion was introduced as the "Asian model," in which a distorted version of democratic capitalism was adopted in a geographic region of the world on the basis of what were called "Asian values." But as Chris Patten, former governor of Hong Kong, said in his recent book, " 'Asian values' has been a shorthand for the justification of authoritarianism, bossiness and closed collusion" (Patten 1998: xii). The Asian Third Way consisted of two interrelated third ways: one between the free market and socialism, and the other between democracy based on the rule of law and totalitarian dictatorship.

Hidden Costs of Industrial Policy

Export-oriented industrial policies were the key element in the definition of the Third Way between free markets and statism in Asia.

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José Piñera is a Distinguished Senior Fellow at the Cato Institute and President of the International Center for Pension Reform in Santiago, Chile.

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It is true that the weakness of the banking sector has been the "trigger" of the current Asian crisis. But the real question is, Why was there such a pervasive government intervention in bank lending criteria and such weakness in bank supervision? The opaque and incestuous relations between banks, conglomerates, and governments were a way to evade the discipline of the market and benefit special interests. The so-called industrial policies were a code word for creating wealth through economic dirigisme rather than market competition. The restrictions on foreign investment were designed to protect oligopolistic private-sector structures and direct money toward whichever industries a group of supposedly "visionary" government officials decided had "dynamic" comparative advantages. In Japan, the "visionaries" were in the legendary MITI; in Korea, they were in the planning ministries and the *chaebols*; in Indonesia, they were technocratic bureaucrats. In each case, the rationale of industrial policies proved a very convenient way to obscure huge malinvestment and, in many instances, outright corruption.

Politicization of the Market

But one cannot permanently have a system of free enterprise coupled with an authoritarian or corporatist political system. If a country lacks the rule of law, a free press, and political accountability, sooner or later vested-interest groups—be they business, trade unions, or political groups—begin to distort the system in their favor. Of course, the rationale of corporatism, so entrenched in Japan and some European countries, was again instrumental in justifying government, business, and trade-union collusion. Substituting dirigisme for the market, whoever was doing the directing introduced important economic distortions that reduced productivity growth, created or destroyed wealth by government decision, and produced intolerable injustices.

There is here an important lesson for China. I believe that inside China there are strong forces working for economic and political liberalization. Among them are the policies of the late Deng Xiao Ping; huge foreign investments, especially those by the overseas Chinese community; the impact of those 250,000 Chinese students educated in the United States in the last two decades; the increasing media linkages to the free world; and finally the role of the Hong Kong takeover in changing China. But it is a race between those forces and others that are trying to use partial economic freedoms in their favor through manipulation of the state and the political sector. Weaknesses in the banking sector, gross inefficiencies in the state-owned enter-

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prises, and increasing corruption may finally turn China into more of an Indonesia than a Singapore.

Ending the Asian Crisis

The way out of the Asian crisis is to abandon the Third Way—in both its economic and its political dimensions—and introduce more free markets, more civil liberties, and more democratic accountability. Introducing capital controls is not the answer. The world (including the emerging countries of Asia) needs the integration of capital markets to channel savings from mature economies to those with projects that might provide a greater rate of return. The Asian economies need to open more to direct foreign investment, discard ill-conceived limits on the ownership of corporations, and remove restrictions on the entry of foreign banks and other financial institutions. Chile, supposedly the model country for capital controls, has no restrictions on the entry of foreign banks. Foreign participation in the banking industry stands at around 20 percent there. Meanwhile, in the mid-1990s foreign-owned banks accounted for roughly 5 percent of bank lending in South Korea, Thailand, and Indonesia. The real issue is proper banking supervision, especially of short-term debt in currencies different from those of the lenders. Strict supervision and well-designed rules are needed. But that is not an argument for so-called capital controls. Portfolio investment is necessary, even of the short-term kind.

Protectionism is also the wrong answer and one that deepened the depression of the 1930s. The Chilean Congress has approved a reduction of the 11 percent flat tariff (already a key reform because its flatness prevents the distortionary effects of varying rates and especially the political lobbying for differential tariffs) to a 6 percent flat tariff by 2003. From there to zero should be a small step for legislators, but a great leap for free trade.

In Asia, Central Provident Funds with individual accounts were an advance with respect to pay-as-you-go social security systems. But the allocation of the accumulated capital has been done by government bodies rather than competitive private enterprises in a transparent capital market. More than overinvestment, Asia has had a crisis of malinvestment, as will always be the case when you substitute the political committee for the market. It is now time to decentralize the management of the individual pension accounts. And, of course, you cannot have a Third Way in exchange rate policy: You must choose either a full currency board or a totally flexible exchange rate regime.

Lessons for Latin America

For Latin American countries, the Asian crisis should confirm the importance of a coherent free-market strategy and the need to uphold

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the rule of law, honest government, and democratic freedoms. Those Latin American countries that have most followed such a path—especially Chile, Argentina, Peru, and, to a lesser but important extent, Mexico—will weather the crisis and rebound strongly in the next two years. The fate of Brazil, important as it is, rests in the leadership of recently reelected President Fernando Henrique Cardoso, not on the International Monetary Fund or the U.S. Treasury. Even though Brazil has taken great steps forward in privatizing huge state-owned companies, it urgently needs radical fiscal and pension reform. In time Latin America should go even further and join a dollar area, probably as part of a hemispheric free-trade area. In the 21st century we could see a whole hemisphere committed as never before in its history to economic, civil, and political liberties.

Why Asia Will Follow the Freedom Path

I believe that there are many megatrends that will lead Asia, sooner rather than later, to follow the freedom path. Let me emphasize only two. First, the communications revolution, especially the Internet phenomenon, is spreading a real "freedom virus" all over the world. And second, the outstanding success of the United States, a model that in a post-Cold War world will be emulated without the ideological and historic prejudices that obscured the vision in the past. Once this happens, the enormous strengths of the Asian economies—abundant human capital, high savings rates, low taxes, and an entrepreneurial spirit—will manifest themselves and produce a lasting period of prosperity.

Conclusion

From this perspective, the Asian crisis may turn out to be the fall of a second Berlin Wall, that of a supposedly Third Way to development and freedom. And this could not only bring enormous benefits to the rest of the emerging world—especially to African countries that are tempted to follow the Asian model—but also give impetus to the necessary restructuring of Europe's faltering welfare state. Monetary unification and the coming pension crisis will reveal the entrenched rigidities and corporativism of the Old World's own brand of the Third Way.

Let's face it. The Third Way will keep emerging countries permanently in the Third World, and maybe produce an historical anomaly, the descent of a European country to Third World status in a few decades. There are two big truths being revealed by the current world situation, especially by the contrast between Asia and the United

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States: first, freedom is indivisible, and second, "indivisible freedom" works.

If this is well understood and there are leaders who dare to do what is correct rather than what short-term political considerations dictate, the pain being inflicted by this crisis, rather than marking the agony of global democratic capitalism, may well signal the birth of an era of global freedom.

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A Monetary Constitution for Argentina: Rules for Dollarization

Steve H. Hanke and Kurt Schuler

When Carlos Menem was first elected President of Argentina in 1989, the economy was in shambles. Since then, his governments have delivered an almost unbelievable set of free-market reforms. In consequence, Argentina's economic freedom ranking has improved more than any other country in the world in the 1990s, moving from 59th in 1990 to 7th in 1997 (Gwartney and Lawson 1998).

The linchpin for Argentina's economic reforms has been the currency board–like system that was instituted on April 1, 1991. Argentines call this system, and the wider economic reforms it has spurred, "convertibility," an uncommon term for an unusual system. The system has some peculiar features that most observers neglect.

An orthodox currency board system is a monetary institution that issues notes and coins. These notes and coins are backed with a minimum of 100 percent (up to a maximum of 110 percent) of foreign reserve currency, and they are fully convertible into the reserve currency at a fixed exchange rate on demand. In addition, an orthodox currency board cannot act as a lender of last resort, does not regulate reserve requirements for commercial banks, only earns seignorage from interest on reserves.

Argentina's convertibility system engages in limited lender-of-last-resort activities; it regulates reserve requirements for commercial banks; it can hold up to one-third of the dollar-denominated reserves it keeps to back its monetary liabilities in the form of bonds issued by the government of Argentina; and the Convertibility Law only

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Steve H. Hanke is Professor of Applied Economics at the Johns Hopkins University in Baltimore, Maryland, and President of Toronto Trust Argentina in Buenos Aires. Kurt Schuler is a Senior Economist with the Joint Economic Committee of the U.S. Congress. This article was written before he joined the JEC staff; the views expressed are his own. An earlier version of the article appeared in *Friedberg's Commodity and Currency Comments Experts' Report* (Hanke and Schuler 1999).

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requires that the central bank's monetary liabilities be covered by a minimum of 100 percent in dollar-denominated assets. Consequently, when the assets are greater than 100 percent, the one-to-one link between foreign reserves and the monetary base can be broken, indicating discretionary sterilization.

These deviations from currency board orthodoxy result in less than a perfect unification of the peso and the U.S. dollar (Walters and Hanke 1992). Even though the peso-dollar exchange rate has remained absolutely fixed at 1-to-1, there has often been speculation that the peso will be devalued. Interest rates in pesos have accordingly been persistently higher than interest rates in U.S. dollars within Argentina. During the past year, the spread between interest rates on Argentine 30-day loans in pesos and dollars has varied between 50 and 440 basis points.

To make Argentina's currency unification with the dollar complete, President Menem suggested, in January 1999, replacing the peso with the dollar. And on February 10, 1999, one of us (Hanke) presented a dollarization report to President Menem in Buenos Aires. Much of what follows is contained in that report (Hanke and Schuler 1999).

Dollarization is Desirable

Because Argentina does not have an orthodox currency board and has been unwilling to make the system orthodox, as we have advocated (Hanke and Schuler 1991a, 1991b; Hanke, Jonung, and Schuler 1993: 72–4, 77), dollarization is desirable. A dollarized monetary system works almost like an orthodox currency board system. The main difference is that under dollarization a country loses seignorage (the profit from issuing the monetary base) to the United States, whereas under an orthodox currency board, it retains the profit. Let us now consider the costs and benefits of dollarization compared with Argentina's currency board–like system.

The main cost of dollarization would be lost seignorage. At present, Argentina earns perhaps 750 million pesos a year in seignorage. Since the size of Argentina's economy, as measured by gross domestic product (GDP), is roughly 340 billion pesos, seignorage is only about 0.22 percent of annual GDP. In other low-inflation countries, the seignorage can be as much as 1 percent. Argentina's long history of inflation before the Convertibility Law has made Argentines less willing to hold local notes and coins than people in other countries with low inflation, so seignorage in Argentina is lower than average. Since the peso-dollar exchange rate is 1-to-1, there would be almost no one-time costs associated with converting computer programs and cash

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registers from pesos to dollars. In consequence, the administrative costs of dollarizing Argentina would be very small.

The major benefit of dollarization would be reduced interest rates in Argentina. With no peso-dollar exchange rate, currency risk would be eliminated, and the spread in interest rates between pesos and dollars for loans within Argentina would be closed. As of late January 1999, the interest rate for overnight interbank loans in pesos was about 1 percentage point higher than the rate in dollars, with the spread widening to about 5 percentage points for 1-year interbank loans. For nonbank borrowers, the spreads are higher. It is true that people who want to pay lower interest rates can borrow in dollars, but that exposes them to a currency risk that many do not wish to take, given Argentina's long history of devaluations before the Convertibility Law.

By eliminating currency risk, dollarization would reduce interest rates. In consequence, Argentina's trend rate of growth would be higher and the variability of annual growth would be lower with dollarization than with its currency board–like system. Indeed, a government memorandum estimates that lower interest rates resulting from dollarization would add 2 percentage points to the trend rate of economic growth (Warn 1999). This benefit exceeds the cost of seignorage lost (0.22 percent of GDP).

Even using the conventional benefit-cost framework, as we have just done, leads us to conclude that the benefits of dollarizing Argentina clearly outweigh the costs. However, when evaluating alternative monetary regimes, conventional benefit-cost analysis fails to capture important benefits and costs, namely the wants of consumers. The "consumers" of money are those who use it—almost everyone except for young children. Rather than using as their starting point a determination of what characteristics consumers find desirable in money, economists simply assume that a well-intentioned, competent, politically independent central bank would produce the best outcome, and that is where they begin their calculations. In the case of Argentina, this is as unrealistic as assuming that a government-owned telephone monopoly would produce efficient, low-cost service.

Argentines have shown that the characteristics they want in a currency are those that the dollar has: low inflation, full convertibility, the prospect of continued good performance in the future, and international acceptability. The Convertibility Law succeeded, where past monetary reforms had failed, because it made the peso a close substitute for the dollar. However, the dollar is still perceived by consumers as being superior to the peso. Dollarization would allow consumers fully to take advantage of the perceived superiority of the dollar.

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Government officials have on a number of occasions said that the reserves backing the peso should be considered the property of holders of the peso monetary base, held in trust by the central bank. That is a commendable attitude, but one that consumers do not fully believe. Dollarization would privatize the reserves by distributing them to the Argentine people who hold peso notes and coins. Any doubts that consumers might have about their peso property rights and the durability of the 1-to-1 peso-dollar exchange rate would be eliminated.

Most Objections to Dollarization Are Incorrect

Argentina is not the only place where there has recently been public debate about dollarization. It has also been debated in Hong Kong (Schuler 1998). People have already made several objections to dollarization in Argentina; other objections that have been made in Hong Kong may soon be repeated in Argentina. Most of the objections are mistaken. We will examine the more important ones here.

The most passionate objection to dollarization is not economic, but political. This should not come as a surprise. The choice of alternative monetary regimes always contains political elements. Some Argentines consider that the peso is an essential symbol of Argentina, and think that dollarization would infringe on Argentina's sovereignty. However, the several dollarized countries that are independent do not find that dollarization constrains their independence, or that a locally issued currency is essential to sovereignty or to national pride; neither would Argentina. Dollarization should not be considered a blow to national pride. Rather, it is a logical extension of the principles underlying the Convertibility Law.

Under a currency board (or a monetary union), a nation gives up monetary policy sovereignty. The same is true under dollarization. When compared with a monetary union, however, the great advantage of a currency board or dollarization is that *political* sovereignty is not lost, because a nation can unilaterally enter or exit a currency board or a dollarized system. In practice, this is not the case with a monetary union. Once a nation enters a monetary union, political sovereignty is given up because it is extremely difficult to unilaterally exit a monetary union.

The claim that a national currency is a symbol of sovereignty also inappropriately mixes political concepts with economic concepts. National sovereignty is the ability of a national government to have some freedom of action in foreign policy and other international political matters without being subject to coercion by other nations; it is not the ability of a government to restrict the political or economic

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freedoms of its citizens. In a market economy, the fundamental concept is not national sovereignty but individual freedom of choice. The economist W. H. Hutt (1940) coined the term "consumers' sovereignty" to express this idea.

The most frequent economic objection to dollarization is that it would deprive Argentina of flexibility in monetary policy, even the limited flexibility of its currency board–like system. The critics assert that dollarization would rob Argentina of the means to cope with external shocks, because the monetary authority would lack flexibility and room for discretionary policy. This objection is a neat theory, but it is contradicted by the empirical evidence. Annual growth rates in developing countries without monetary flexibility—those with currency boards or dollarized systems—were over 50 percent greater than in those with central banks and monetary flexibility during the 1950–93 period. Furthermore, the variability of those growth rates, as measured by their standard deviations, was virtually identical, indicating that a lack of monetary flexibility did not result in a greater incidence or vulnerability to external shocks (Hanke 1999, Schuler 1996).

Related to this general objection is a more specific one: that dollarization would eliminate the Argentine central bank's capacity to act as a lender of last resort. Contrary to what most economists think, it is undesirable to have a central bank as a lender of last resort. All the most expensive rescues of banking systems have occurred under central banking. Argentina, in fact, holds the record for the most expensive bank rescue in proportion to the size of its economy: the banking crisis of 1980–82 cost 55 percent of GDP (Caprio and Klingebiel 1996). Argentina already has in place a liquidity fund of $6.7 billion (BCRA 1998). The key provision of the fund, which was established in December 1996, is something called the Contingent Repurchase Facility. Under this program, the Argentine central bank has the option to sell certain domestic assets for dollars to a group of banks subject to a repurchase clause. As of October 1998, 14 international banks were participating in the facility. The assets underlying the repurchase facility included $6.2 billion in Argentine U.S. dollar-denominated bonds and up to $500 million in dollar-denominated Argentine mortgages. Consequently, the facility can provide emergency liquidity, but it is not a lender-of-last-resort arrangement which by its nature also provides the government with the power to inflate.

Argentina's banking system has become very internationalized under the currency board–like system, with foreign banks accounting for about 41 percent of the banking system's total deposits and 64 percent of the deposits in private banks (BCRA 1998). This has dramat-

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ically increased the banking system's access to liquidity provided by international capital markets. The Repurchase Facility, along with the extensive internationalization of Argentina's banking system (which makes the international banks' head offices, in effect, lenders of last resort to local branches), ensure that arrangements for emergency liquidity are adequate for a dollarized system. Furthermore, dollarization does not prevent the government from being a lender of last resort: the government's fiscal authorities can lend to banks directly. Direct lending by the government is likely to be more transparent than lending by a central bank.

Another objection is that Argentina would be hurt if the dollar someday becomes an unstable currency with high inflation. The solution to this potential problem is to extend the considerable freedom that already exists for people in Argentina to use any currency. Though initially the dollar would be the most widely used currency, people would be free to use whatever currency they prefer. If people wish to make contracts specifying payment of wages, business expenses, or loans in euros, yen, or even Brazilian *reals*, they should be allowed to do so. That way the Argentine people would be able to use the most stable currencies in the world.

Some economists have claimed that Argentina is not part of an "optimum currency area" with the United States, because the economic forces affecting the two countries are different. Dollarizing Argentina, they argue, would prevent the government from ever using the exchange rate as a tool of monetary policy. We reply that the theory of optimum currency areas, as economists generally think of it, is incorrect. A government, a central bank, or an economist sitting in his armchair cannot determine what an optimum currency area is, any more than they can determine the optimal type of telephone service for a country. The only way to determine an optimum currency area is to allow people freedom of choice and then see what happens (White 1989). The Argentine people have shown—by their preference for the dollar and for a peso with a fixed exchange rate to the dollar—that for them Argentina is part of an optimum currency area with the United States.

Still another objection is that dollarization is an inappropriate basis for a single currency in the Mercosur, because other countries, especially Brazil, will not dollarize. Again, the goal for Argentina should be the retention of political sovereignty and the enhancement of consumer sovereignty. A Mercosur monetary union would not achieve this, in principle, whereas dollarization would do so, in principle and in practice.

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Dollarization is not "too simple" for Argentina. On the contrary, the more financially sophisticated Argentina becomes, the greater the value of a simple and transparent monetary system. Central banking is central planning in money, and central planning works as poorly in money as it does in agriculture or in industry. That is why the historical performance of central banking has been much worse than the performance of market-led monetary systems, such as currency board or dollarized systems. Inflations, devaluations, exchange controls, large fiscal deficits, and currency confiscations have been absent in these systems.

Because the currency board–like system retains some features of a central bank, the peso has experienced periodic speculative attacks. Especially during speculative attacks, interest rates in pesos have been much higher than comparable rates in dollars. We think that dollarization would eliminate the rationale for speculative attacks. However, in a speech made last November, Alan Greenspan, chairman of the Federal Reserve System, said, "It is questionable whether a sovereign nation, otherwise inclined to economic policies that are 'off the wagon,' can force itself into 'sobriety' by dollarization" (Greenspan 1998: 6).

Greenspan's criticism has been repeated in the Argentine press, and Lawrence Summers, Deputy Secretary of the U.S. Treasury, has recently made a similar claim. It is a version of the idea that sound fiscal policies must precede a sound currency, as if the monetary system exerts no influence on government finance.

Argentines know from their own experience, though, that the monetary system *does* exert considerable influence. It is generally recognized that without the Convertibility Law, economic reforms in Argentina would not have progressed so far and so fast. Other countries have had similar experience. In a study of 98 developing countries during the period 1950–93, Hanke (1999) found that fiscal deficits were, on average, 65 percent larger and 1.4 times more variable in countries with central banks than in those with currency boards or dollarized systems.

Dollarization would not absolutely guarantee sound economic policies, but no system could. The important thing is that dollarization would improve the odds that Argentina would continue to follow sound policies, much as the Convertibility Law greatly improved the odds that Argentina would implement sound policies in the first place.

In Hong Kong, some critics of dollarization have claimed that it would require huge foreign reserves beyond those necessary to convert the monetary base into U.S. dollar assets. That is incorrect. Dollarization requires only foreign reserves to cover the monetary base (M0),

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not reserves to cover broader measures of the money supply that include deposits at commercial banks, such as M1, M2, or M3. As in an orthodox currency board system, or in a central banking system in normal times, it is the responsibility of banks to hold reserves sufficient to meet the demands of their customers to convert deposits into notes.

Under a currency board, dollarization, and central banking alike, the reserves that banks hold in excess of legal requirements are ordinarily only a few percent of their total liabilities. Under dollarization, peso deposits would become dollar deposits of equivalent value at 1 dollar = 1 peso; they would not be converted into actual U.S. dollar notes. Apparently, no country that has ever dollarized has done so by converting all local-currency bank deposits into U.S. dollars, so it is bizarre to claim that dollarization would require such an operation. Depositors would have no more reason to make mass conversions of U.S. dollar deposits into U.S. dollar notes than they now have to make mass conversions of peso deposits into peso notes. Depositors would also have no reason to switch deposits from some banks to others under dollarization. The assets and liabilities of banks would be the same as they are now. Only the unit of account would change. Expressed in terms of U.S. dollar values, nothing would change. The investment portfolios of banks, and hence their creditworthiness, would stay the same.

Critics will no doubt devise other objections to dollarization, but that is no reason for dismissing dollarization. It is possible to make objections about any monetary system. However, the true test of a monetary system is experience. There is ample historical and current experience with official and unofficial dollarization. No far-fetched conjectures are necessary. If you want to know how dollarization works, look at Panama or Puerto Rico. Dollarization works well there and elsewhere.[1] It does not encounter the problems that critics claim would arise. Purely hypothetical objections are not sufficient to outweigh the practical success of dollarization.

Dollarization Should Take a Liberal Form

The government of Argentina is considering at least two forms of dollarization: unilateral dollarization, which can occur without a treaty, and a limited treaty under which Argentina might regain some of the seignorage it would lose from dollarization and gain access for

[1]For an excellent study of Panama's experience with dollarization, see Moreno-Villalaz (1999).

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Argentine banks to the discount window of the Federal Reserve System as a source of liquidity.

Our own preference is for unilateral dollarization, now rather than later. The sooner the government eliminates the lingering uncertainty in the currency board–like system, the sooner interest rates can fall and the sooner Argentina's economy would benefit. Unilateral dollarization does not require the approval of the U.S. government or the involvement of the Federal Reserve System.

Argentina would need about $15 billion to replace the peso monetary base with dollars. This swap of currencies would be feasible to implement, because, in consequence of the Convertibility Law, the central bank's liquid reserves are about $24 billion. The resulting currency swap would generate a seignorage benefit for the U.S. government, so it is hard to understand why the United States would disapprove of dollarization in Argentina. Even if it did, however, consider that of the total supply of U.S. dollar paper money, which is about $470 billion, 50 to 70 percent is held outside the United States. Almost none has migrated abroad with the official approval either of the U.S. government or of the governments whose people hold the dollars. Russians, for example, have acquired over $40 billion of dollar notes through normal channels of trade, in spite of efforts by the Russian government to discourage the holding of dollars and to prohibit their use in retail trade. Argentina could acquire U.S. dollars in a similar manner. The approval of the U.S. government would be convenient to have, but it is not essential. Even if the U.S. government actively disapproves, Argentina could still dollarize. It might have to move settlement of interbank payments from New York to someplace outside the United States, but that would create no great problems; at various times, Panama has done so.

Dollarization may require minor changes in financial regulations, accounting rules, and so on. The government, in consultation with the financial community, could appoint a committee of experts to examine matters and make recommendations. At the current exchange rate, dollarization should create no legal problems because amounts specified in contracts would not change. Dollarization would not create any gaps in financial markets or in reference rates such as base lending rates. On the contrary, markets in dollars are much bigger and more extensive than markets in pesos, so it would be easy to find a dollar analog for any contractual obligation in pesos.

Under unilateral dollarization it may still be possible for Argentina to negotiate a treaty under which Argentina would regain some of the seignorage it would lose from dollarization. Even without a treaty, the loss of seignorage would be much smaller than the potential gains

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from eliminating currency risk, reducing interest rates, and stimulating higher economic growth.

In our opinion, a limited treaty between Argentina and the United States that would allow Argentine banks to have access to the Federal Reserve's discount window would be undesirable (for general reasons explained in Selgin 1996: chaps. 9–12). Access to a lender of last resort has made Argentine banking crises more costly and frequent than they otherwise would have been. The banking crisis of 1980–82 cost 55 percent of GDP. The banking system experienced another crisis in 1989–90, and another during the Tequila crisis of 1995 (Caprio and Klingebiel 1996: 15, 26–7). Only during the last crisis did the government make lasting reforms to improve the banking system by liquidating poorly managed, government-owned banks. Without the Convertibility Law, which limited the ability of the central bank to act as a lender of last resort, it is doubtful that the reforms would have occurred.

Argentina already has in place a Contingent Repo Facility of $6.7 billion, as we have mentioned. Combined with the extensive internationalization of Argentina's banking system, current arrangements for emergency liquidity are adequate for the needs of a dollarized system. The experience of Panama's highly internationalized banking system has been that systemwide banking crises do not occur, because the system has access to a huge worldwide pool of liquidity in dollars.

Finally, we do not favor a formal treaty because despite the good long-term record of the dollar, there is no reason to compel Argentines to use the dollar, as a treaty might imply the government should do. The dollar can be a legal tender in Argentina without being a *forced* tender. Legal tender simply means that the dollar is acceptable for payments where the parties to a contract agree, and perhaps that it is acceptable if no currency is specified in a contract or an agreement. It is possible for multiple currencies to be legal tender simultaneously. All the major international currencies should have legal tender status in Argentina, and the government should consider accepting payments for taxes in euros and perhaps yen as well as dollars. (Payments would be accepted at market rates of exchange.)

Electronic payments are changing rapidly as computers and communication become increasingly cheap. It is possible that in the future banks will develop currencies based, for example, on baskets of commodities that will be superior to currencies issued by national governments. Argentine law should not prevent people from using newly developed currencies if they wish. Under the form of dollarization we propose, the dollar would be the predominant currency in Argen-

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tina for many years, but if Argentines decide they prefer some other currency instead, they should have complete freedom to switch.

In closing this section, we are obliged to comment on the proposal to establish a Mercosur monetary union. Even if a monetary union could be established in Mercosur, we are skeptical that could ever produce a stable money of a quality equal to the dollar. Dollarization today is vastly superior to a Mercosur monetary union. Indeed, the dollar is the king of currencies and will remain so for the foreseeable future. Most of the world's interbank transactions are in dollars and nearly all the world's trade in commodities is in dollars. Invoicing patterns for manufactured goods are a more mixed picture, but virtually all U.S. exports are priced in dollars, and an amazing 88 percent of U.S. imports are in dollars. In Japan, the world's second-largest economy, 36 percent of exports and 70 percent of imports are invoiced in dollars. Finally, apart from gold, about 70 percent of official reserves of foreign exchange held by non-European governments are dollar denominated (McKinnon 1998).

When Mercosur countries can unilaterally unify their currencies with the dollar via either a currency board system or official dollarization, it is hard to understand why they would even consider establishing a monetary union, a new central bank, and a new currency, the "Latino."

A Specific Proposal for Dollarizing Argentina

Official dollarization would require the monetary base (peso notes and coins, plus peso sight deposits of financial institutions with the central bank) to be swapped into U.S. dollar assets—notes, bank deposits in the United States, easily marketable assets such as U.S. Treasury bills, or some combination. Dollarization, in the rapid form that we envision, can be started immediately and largely completed within 30 days according to the steps below. A schedule of 30 days is realistic, because other countries have made more complex monetary reforms in less time.

To dollarize Argentina, the following steps should be taken:

1. Ensure that the foreign reserves of the central bank are at least equal to the monetary base. True foreign reserves exclude Argentine public bonds. In late January 1999, they exceeded the monetary base.
2. Announce that effective immediately, all peso wages, prices, assets, and liabilities are U.S. dollar wages, prices, assets, and liabilities at the rate of 1 dollar = 1 peso. No commission fees will be permitted for converting values in pesos into their equiv-

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alents in dollars. Expressed in terms of U.S. dollars, nothing will change during dollarization.

Bank deposits and loans bearing fixed interest rates will continue to bear the same interest rates until they expire, except now the principal and interest will be payable in dollars. Interest rates in dollars will probably be lower than rates were in pesos just before dollarization. Borrowers will be able to benefit from lower interest rates if they can refinance their debts; if not, they will be no worse off than they would have been under the currency board–like system, because, in terms of dollars, they will be paying equivalent amounts at the same rates of interest as they were paying in pesos.

Dollarization will cause some redistribution of income: In general, new borrowers of dollars will pay less and lenders will earn less than they do now, because they will be unable to lend in pesos. But lenders will also enjoy some benefit, because there will no longer be any possibility of a devaluation of the type that has bankrupted banks in Asia. Generally, lower interest rates will benefit Argentina's economy by enabling businesses and consumers to borrow for projects they otherwise could not undertake.

3. Immediately replace the peso with the dollar as a unit of account. Because the exchange rate is 1-to-1, no transition period is necessary. No changes in bookkeeping, computer systems, or prices on store shelves will be necessary.
4. Immediately replace peso deposits at the central bank with U.S. dollar assets. In 1995 Argentina already took a step in that direction by moving settlement of payments from peso accounts at the central bank to a dollar account at a bank in New York. This step would simply finish the process.
5. Retire peso notes and coins from circulation, the bulk of them preferably to be retired during the transition period. How quickly that can be accomplished depends on how quickly the central bank can obtain U.S. dollar notes. It is desirable to replace the bulk of peso notes during the transition period. Once retirement of peso notes begins, banks will not be allowed to charge commission fees for replacing peso notes with dollar notes. After the period for retiring peso notes from large-scale circulation is complete, banks and the government will continue for, say, five years to accept peso notes, so that holders of the notes have time to redeem them. However, old peso notes will no longer be used for hand-to-hand payments. After five years, the presi-

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dent of Argentina should have the power to demonetize all peso notes by decree.

We favor replacing peso notes and coins alike with dollar notes and coins, but Argentina could retain locally issued coins as Panama does.

6. Reorganize the central bank to recognize that it no longer issues money. The central bank will cease to be an institution making monetary policy. However, it can continue to have a role in the financial system regulating financial institutions and gathering financial statistics.

Some people may think that dollarization, if adopted, should be only temporary. Historical experience, in contrast, indicates that dollarization in the form we have proposed should be permanent. We propose to continue allowing Argentines to use any currency but to prevent the government from issuing a currency again. For Argentina, a government-issued currency has always been a curse. The Convertibility Law has made the peso almost as good as the dollar, but it is still not as good. Dollarization in the form we have proposed would ensure that Argentines have the freedom to use the world's best currencies, and would make it more difficult to return to the days of a bad national currency.

A Monetary Constitution for Dollarization

The following model statute is meant to suggest the main features that are desirable for a law on dollarization. Legal technicalities may require an actual statute to be somewhat different.

1. The Banco Central de la República Argentina (BCRA) shall cease to issue pesos. It shall withdraw from circulation the Argentine peso monetary base and shall replace it with U.S. dollars at the exchange rate of 1 dollar = 1 peso. The BCRA shall preferably accomplish the bulk of this task within 30 days after this law enters into force. Peso notes currently accepted for redemption into dollars shall continue to be accepted by the BCRA or the government for five years after this law enters into force. After five years, all peso notes in circulation may be demonetized by a decree of the Executive Power.
2. Wages, prices, assets, and liabilities shall be converted from pesos to U.S. dollars at the exchange rate of 1 dollar = 1 peso. By 30 days after this law enters into force, wages and prices shall cease to be quoted in pesos.

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3. Interest rates and other financial ratios shall remain the same in U.S. dollars as they were in pesos. The maturities of loans and other financial obligations shall remain unchanged.
4. The Executive Power may appoint a committee of experts on technical issues connected with this law to recommend changes in regulations that may be necessary.
5. Nothing in this law shall prevent parties to a transaction from using any currency that is mutually agreeable. However, the U.S. dollar may be established as the default currency where no other currency is specified.
6. Previously enacted legislation conflicting with this law is repealed.
7. This law becomes effective immediately.

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Lessons from the Monetary Experience of Panama: A Dollar Economy with Financial Integration

Juan Luis Moreno-Villalaz

Panama's monetary system has the following characteristics: (1) The U. S. dollar is the medium of exchange, while the balboa, the national currency, is a unit of account and exists only as silver coins; (2) capital markets are free, with almost no government intervention or restrictions on banking transactions, financial flows, or interest rates; (3) many international banks operate in Panama; and (4) there is no central bank. As such, the economy of Panama can be considered a "control case" in a simulation experiment, where the monetary and macroeconomic equilibrium process can be studied without financial sector distortions, government intervention, or central bank policies. Hence, Panama's experience reveals the "experimental market answer" to many macroeconomic issues, and the central importance of financial integration.

The Monetary Experience of Panama

Financial Integration

In 1904, the U. S. dollar became legal tender in Panama. In 1970, a new banking law allowed Panama's monetary system to become integrated with the world financial markets, through the participation of a large number of international banks. Banks were attracted to Panama to do offshore banking, but the majority also operate in the local market. Equilibrium in the banks' portfolios implies that banks are indifferent, at the margin, between using their resources locally

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or abroad, and therefore they adjust their portfolios accordingly. An excess supply of money leads to higher bank liquidity. Banks evaluate profitable projects (at acceptable levels of risk), and when these are exhausted, they place excess liquidity abroad, directly or via the intermediation of international banks in Panama. The opposite is true when there is an excess demand for money or credit.

The adjustment of banks' portfolios is a key mechanism for the monetary system, enabling it to vent an excess demand or supply of money and to smooth out fluctuations. Otherwise, variations in foreign exchange would create fluctuations in the level of expenditures, which has not been the case. Access to international capital increases the availability of resources, which allows the level of investment to be independent of, and not limited by, local savings. Thus, credit and deposits by individual banks show no correlation (Sjaastad 1977). This indifference of banks between allocating their resources in the local or foreign market is what we call "financial integration."

Interest Rates

The use of the dollar and the existence of a large number of banks have created a very competitive banking system in Panama, with low country risk and no devaluation risk. Under financial integration, interest rates are determined by, and close to, world market rates, adjusted for transaction costs and risk. International banks conduct local retail operations and operate wholesale via interbank deposits, borrowing abroad and lending to local banks, or receiving local funds to invest abroad, serving as brokers or intermediaries. International banks pay close attention to the London interbank offered rate (LIBOR), the cost of their alternative source of funds. The average deposit rate in Panama is less than 1 percentage point above LIBOR (local banks pay somewhat higher rates). The average lending rate to the commercial sector is now less than 2 percentage points above the U.S. prime rate. Panama's interest rates compare favorably with interest rates in other Latin American countries, where dollar-equivalent rates for loans, with few exceptions, are around 20 percent a year or higher, and interest-rate spreads are normally 9 to 18 percentage points, but only around 4 percentage points in Panama.

Stability of the Economy

Panama's inflation has been low and stable. The average rate of consumer price inflation in the 1961–97 period was 3 percent per year, 1.4 percent excluding the years 1973–81, and less than 1 percent today. Panama's inflation exceeded 10 percent only in 1974 and in 1980, due to the worldwide inflation that resulted from increases in

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the price of oil. This low inflation is explained by the absence of an excess supply of money, and by the inability of the government to monetize its deficit. In Panama changes in the price level arise mainly from world inflation, adjusted by changes in internal policies (protectionism and taxes); price transmission comes directly through the prices of imported goods. Local prices adjust to expected world inflation. Panama's inflation compares favorably with inflation in the rest of Latin America, where inflation of over 10 percent a year is common. In Argentina and Brazil inflation has exceeded 1,000 percent in some years.

In Panama, in spite of microeconomic distortions, economic growth has been high and relatively stable. In the 1960–71 period and the 1978–81 period, average GDP growth was 8.1 percent per year and 2.5 percent in other years. Except for a small decline in 1983, and during the crisis of 1988–89 (the result of sanctions imposed by the United States), Panama's GDP has grown every year since the 1950s. The stability of Panama's economy is a consequence of its monetary system and also the stability of its income from exports, which are a large percentage of the economy and are mainly services related to its geographical position. Panama's volatility indices for GDP and the terms of trade have been 2.9 and 7.9, respectively (excluding 1988–89). For Latin America as a whole the volatility indices were 4.7 and 15.1 (IDB 1995).

Economic stability is reinforced because the absence of domestically produced money means that public expenditures are effectively constrained by available financial resources (the hard budget constraint). Policies creating fiscal imbalances do not exist. When there is a need to balance the budget, immediate cuts in expenditures are made, particularly in investments, or occasionally taxes are increased. Public enterprises are financially self-sufficient; sometimes they achieve this through higher prices. With few exceptions, there are no direct subsidies on prices of goods, and charging more to high-income groups finances subsidies for low-income groups (cross-subsidies). The government deficit can still be large, but it needs to be financed ex ante, as was the case during the 1970s, when average annual deficits were 7 to 9 percent of GDP.

The Real Exchange Rate

The real exchange rate (RER), measured comparing Panama's CPI with respect to the United States, presents two distinct characteristics: (1) a sustained decline of 1.7 percentage points per year as inflation in Panama is lower than in the United States, a long-run trend that

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has resulted in a 46.2 percent real depreciation since 1961;[1] and (2) a narrow range of year-to-year variations, of less than 4 percentage points, with respect to the trend for any given year. This relatively stable RER is a distinct characteristic of Panama, and is a result of its monetary system and the stability of its export earnings. This RER stability is significantly different from the experience of other countries where variations in the RER of 30 to 50 percent in a given year are not uncommon (Edwards 1989). A study by the Inter-American Development Bank found an average volatility index of 13.3 for the RER in Latin America, 4.8 for developed countries, and only 2.3 for Panama (IDB 1995).

Large changes in financial flows do not seem to influence the RER much, or cause volatility. For example, when the banking system opened in 1969–70, outstanding loans to the private sector doubled in three years, without undue price pressures. In the 1973–75 period, net capital inflows averaged 17.0 percent of GDP per year, and during the 1985–86 period, net capital outflows were 9.2 percent of GDP per year, but the RER changed very little in both cases. Also, when restrictions on bank operations were lifted after the 1988–89 crisis, local deposits increased 80 percent in three years, again without instability. Panama's real effective exchange rate (REER), a measure which takes into account other currencies besides the dollar, also fluctuates less than America's REER. Thus, Panama is somewhat insulated from fluctuations in the dollar, due to the large proportion of Panama's direct trade with the United States or within the dollar area.

The fact that Panama's RER is not significantly affected by monetary shocks implies that its value is determined in real markets by relative factor prices, competitive advantage, the terms of trade, productivity trends, taxes, and trade policies. Given that imports account for nearly 40 percent of Panama's GDP, international prices permeate the local price system and support the stability of the RER. In addition, as in many developing countries, the elasticity of supply for factors and production is high in procyclical sectors, which helps maintain the RER; otherwise, as in full employment equilibrium models, an excess demand will increase the relative price of nontradeables and the RER.

Panama has an ample supply of entrepreneurs because foreigners have readily been assimilated in spite of legal restrictions. The economy is in large part commerce and services, while industrial activities utilize simple processes, resulting in highly elastic supplies. Protectionist policies introduced barriers to imports, but mostly for building material, food, and agricultural products. Moreover, whenever de-

[1]Equivalent results hold since the late 1940s (Moreno-Villalaz 1997).

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mand increased, imports were authorized if needed or the government adjusted inventories. Thus, the economy is relatively open at the margin, and supply adjustments can be made without substantial price changes.

The operation of the labor market contributed to dampening relative price changes, due to stable real wages and an elastic labor supply. From 1960 to 1982, the real wages of unskilled workers increased by only 6.8 percent. After 1970, real wages for workers with higher education declined. The elastic supply of labor results from the transfer of labor from the informal to the formal sector, or from rural to urban areas, which keeps real wages at subsistence-equivalent levels. The operation of this mechanism, in a reverse manner, was evident on several occasions. The percentage of urban population remained the same in 1940 and in 1950, in spite of the large increase in employment in the intermediate years (due to a buildup of the U.S. military presence). After the war, the urban migrants returned to the hinterland—the "interior." During the 1963–69 period, GDP grew at 7.7 percent per year and employment in the metropolitan area grew at 5.3 percent per year. However, the rate of unemployment in the metropolitan area remained near 10 percent. During the 1989–90 crisis, nonagricultural employment (in urban areas) decreased by 48,000, but agricultural employment increased by 33,000, indicating reverse migration.

The Adjustment Process with a Unified Currency

Response to Political Crises

In January 1964, a political conflict in the Canal Zone resulted in riots, suspension of diplomatic relations with the United States, and widespread uncertainty. The conflict was not resolved until May of 1964. Purchases of services by residents of the Canal Zone fell 20 percent during the year. By March 31, foreign deposits had decreased 30 percent, and remained at that level until 1965. During the first quarter of 1964, local deposits decreased by 12 percent, but recovered by the end of 1964. As a result of this situation, the economy slowed down, government expenditures decreased by 7 percent, employment and average salaries barely increased, and private construction declined 15 percent. Real GDP grew 4.4 percent, in contrast with 8 percent growth in the previous and following years. To finance their local operations, private banks sold their American bonds, reduced cash and deposits abroad, and brought funds from their home offices. Banks' domestic credit increased by 6.6 percent in the first quarter, in spite of the reduction of deposits. Confidence in the system was

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demonstrated by the opening of a subsidiary of the Bank of America at the end of 1964.

The years 1967–69 were another period of political instability. The new Canal Zone treaties negotiated with the United States were rejected by the Assembly, which in April 1968 resolved to impeach the president. The 1968 political campaign was scandalous and in October, the army overthrew the president. Government expenditures stagnated in 1968, and government investment decreased. Tourism, expenditures in Panama by Canal Zone residents, and credit to the private sector grew less than the trend. To finance local operations banks borrowed abroad. Net foreign liabilities went from $38.7 million in 1968 to $74.0 million in 1969. As on previous occasions, the economic effects of a political crisis were mild: a deceleration of economic growth from 8.5 percent to 7.0 percent in 1968. This slowdown produced a slight downward pressure on the relative increase in prices. In 1966–67, the CPI index in the Unites States grew 2.1 percentage points per year more than in Panama, while in 1968–69, it grew 3.2 percentage points more per year. Those two episodes illustrate how Panama's monetary system has shown a capacity to withstand political shocks without economic crises, by minimizing the capital flight and also as a result of financial intermediation. In other Latin America countries, the monetary system and exchange rate regime become a conduit to convert political crises into economic crises.

The Opening of the Banking Sector

During 1969–70, Panamanian authorities freed interest rates and fully opened the banking sector. Panama immediately developed an international banking system of regional significance and by 1974, 30 international banks had full operations. Assets reached several billion dollars by 1973. As banks did not need to balance separately their external and internal operations, they could use external funds to finance local operations. As new banks joined the system, the overall supply of credit was not affected by the credit ceiling for each bank. As a consequence, the supply of credit was highly elastic, and interest rates were similar to international rates—LIBOR for deposits and LIBOR plus 1.5 percentage points for preferred clients. Capital inflows were large: net capital inflows were 9.2 percent of GDP in 1971–72, and net foreign liabilities for banks operating locally more than quadrupled from 1968 to 1972.

Before 1969, credit was effectively rationed by restricting access to the best clients and lending with low leverage. As a result, there was an excess demand for credit in housing, durable goods, and commerce. The opening of the banking system brought a portfolio

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adjustment. Outstanding loans to the private sector increased 2.2 times from 1968 to 1972. The new availability of mortgages generated a construction boom; annual private construction activities doubled in this period. Economic growth over the 1970–72 period was 8.3 percent per year, in spite of lower export growth. During this period the RER changed little, but the increase in expenditures increased Panama's inflation to a level closer to the U.S. inflation rate. During 1969–70, the CPI index in the United States grew 2.8 percentage points per year more than in Panama, while in 1971–72, it grew only 1.2 percentage points more per year. Thus, in the case of Panama, the opening of the banking sector, which sharply increased market competition and financial integration, did not produce a macroeconomic crisis, as it did in Chile in 1980–82 and Mexico in 1994.

The Oil Crises of 1973–74 and 1978–80

The increases in the price of oil in 1973–74 and again in 1979–80 were typical supply shocks external to the system. In Panama, the government immediately transferred the increases to local prices, including electricity, adjusting directly the relative prices of tradable to nontradable goods, thereby preempting the need to devalue. The increase in prices did not create political problems, as in other countries, because it was clear to the public that no alternative was available. As a result of the oil price increase and world inflation, Panama's CPI increased 31.5 percent from 1972 to 1975, similar to the U.S. increase of 28.5 percent. This indicates a complete price adjustment. The oil crisis produced a real income loss, but part of the cost to the country was compensated for by a reduction of the real value of the external debt due to inflation. For 1974–75 and 1979–80, the annual subsidy due to inflation or negative real interest rates in Panama was 3.5 to 4.1 percent of GDP per year.

At the end of 1973, economic agents reacted to the immediate increase in expenditures, due to the high price of oil, by initially reducing their liquidity and borrowing, subsequently adjusting their expenditures. The banking sector financed the extra expenditures over income. From December 1972 to December 1974, net foreign liabilities more than tripled, from $182 million to $577 million, and banks' claims to the private sector increased 73 percent. Capital inflows, via the banking system, were 13.1 percent of GDP in 1973 and 18.2 percent in 1974. Afterward, in 1976–77, there was a significant decline in real net foreign liabilities, as banks readjusted their portfolios. In 1979–80, the price of oil more than doubled, but its effect on Panama was softened by the increase in income from the new Canal treaty. Altogether, the results were similar to the 1973–75

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experience. For example, the CPI index increased 23.2 percent from 1978 to 1980, compared with 26.4 percent in the United States. In 1979, a large net increase in real capital inflows helped finance short-term excess expenditures, but by 1981–82 net real capital inflows were almost zero and expenditures were adjusted to the income level.

Adjustment to a Large Shock: 1987–89

The Crisis. During the years 1987–89, escalating tensions with the U.S. government resulted in a major political and economic crisis. As a result, in 1987 over $300 million were withdrawn from the banking system (11 percent of local deposits), which cut a construction boom short. As on prior occasions, banks borrowed abroad and reduced their liquid assets to compensate for the loss of local resources, but also reduced lending. In January 1988, a U.S. court indicted Panama's military leader, and in March, the U.S. government imposed economic sanctions on Panama. The sanctions included declaring Panama off-limits for military personnel, compelling American companies not to pay taxes in Panama, ceasing payments to the Panamanian government from the U.S. government (the Canal Commission and the U.S. military), and freezing of all Panamanian government accounts in banks in the United States.

Responding to this shock, banks were closed, and reopened after two months with some restrictions. The government suspended payments of the foreign debt service, which decreased net government outlays by about $400 million per year. This transferred to international banks the brunt of the adjustment cost. Excluded from the restrictions were banks with international licenses and foreign depositors in general. After banks reopened, depositors could withdraw up to 50 percent on current accounts and up to 5 percent or $50 per month on savings accounts, but certificates of deposits remained frozen. These measures favored banks, which were released of responsibility for their liabilities but could collect their assets. Banks were authorized to issue a negotiable document, known as Investment Certificates (CEDIS), that could be used to cancel debts to the banks. In addition, no restrictions were placed on new deposits.

As a result of the crisis, real GDP decreased 15.6 percent in 1988 and 0.4 percent in 1989. Bank credit to agricultural activities was replaced by suppliers' credit, and agricultural production was only slightly affected. Exports fell over $350 million, which was 9 percent of net export income (Moreno-Villalaz 1997). In addition, there were large capital outflows, and firms opened bank accounts abroad. The central government's revenues decreased by $500 million, half their previous level, but because some American firms retained government

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checks in lieu of tax payments (such as salary payments), tax revenues were effectively higher than registered figures.

Adjustment in the Level and Composition of Expenditures. The reduction of income, the lack of credit, uncertainty, and the need to rebuild available cash balances reduced private investment and consumption. Private-sector construction activity collapsed to a third of its previous level. Consumers' expenditures concentrated on necessities and essentials, rather than on durable goods or luxuries. Government salaries were reduced by not paying the "13th month" bonus, and by not enacting statutory salary increases in health, education, electricity, and telephone services. Benefits to new retirees were also delayed. There was an expenditure switch from imported goods to local goods and services. In 1988, nominal expenditures on imports of goods and services declined 34.2 percent, more than the 14.3 percentage decline in nominal GDP or the 23.1 percentage decline in local expenditures.

Price and Other Adjustments. Asset and factor prices adjusted rapidly. The rent on luxury apartments fell more than 30 percent, to a level approximately equal to the cost of interest and mortgage payments. At the lower prices, these apartments were occupied again. The market value of CEDIS had a discount of 15 to 25 percent for local banks. Government bonds were discounted by 50 percent during the crisis, compared to only 20 percent before the crisis. Six-month Treasury bills were discounted by 15 percent. Real estate agencies agreed on a "crisis value discount" of 25 to 33 percent on assessed value for luxury apartments; 15 to 20 percent for upper-middle-class houses, and 10 to 15 percent for middle-class houses. The effective discount on land was 25 to 35 percent. Labor unions made out-of-contract agreements to protect the sources of employment, with reductions in wages, hours worked, unpaid leave, and employment. Those agreements, approved by the Labor Ministry, were not sanctioned by the Labor Code, the Constitution, or labor contracts. In the construction industry a "crisis salary" was agreed upon, reducing wages of skilled workers from $2.27 per hour to $1.70. The median wage of males in the metropolitan area declined by 8 to 15 percent in industry, commerce, banking, and services.

As on other occasions, the crisis produced a slightly downward pressure on the relative increase in prices. During the 1982–86 period, the CPI in the United States grew 0.8 percentage points more per year than in Panama, while in 1988–89 it grew 2.9 percentage points more per year than in Panama. Industrial prices, excluding oil, were

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constant from 1988 to 1989, even though the price of imported products increased 6 to 8 percent. Agricultural prices rose 3.4 percent in 1988 and 10.1 percent in 1989, as the prices of rice, beans, potatoes, chicken, and eggs increased—the result of establishing quotas on 20 agricultural products.

Lessons from the Adjustment Experience

International banks have reacted to the unexpected events or economic shocks in Panama by increasing their exposure and using external funds to support local operations. They have done so in 1964, 1967–69, 1973–75, and 1978–80. The home offices of international banks have functioned as lenders of last resort, providing liquidity to the banking system. This feature has been a shock absorber, a credit reserve that substitutes for central bank reserves and reduces the risk in the economy, even under conditions of strain.[2]

During the oil crisis, Panama's monetary system compelled the government to implement the necessary price adjustments immediately. Relative prices between tradables and nontradables were adjusted solely by the effect of the increase in oil prices. In contrast, where devaluation was the mechanism of adjustment, in countries facing a balance of payments problem, the oil price increase produced changes in the relative prices of tradables and nontradables beyond and different from those caused by the increase in the price of oil. A price distortion was thus induced by devaluation.

The 1988–89 crisis was not the result of the monetary system, but a political shock. Panama's policies and adjustments during 1988–89 were not designed as a deliberate effort to reduce spending on foreign exchange, or to balance external payments, but to adjust the excess of expenditures over income. Consequently, no additional import taxes were imposed; in fact, import taxes on industrial inputs were reduced slightly. Panama's economic agents and policymakers do not differentiate between payments in local and foreign currency because both payments are in dollars, and there is no central bank. Maintaining the exchange rate or an international reserve position is not an objective or a consideration. Panama has been able to efficiently adjust to shocks through private-sector decisions without government intervention.

The Macroeconomics of Panama's Monetary Regime

Macroeconomic Equilibrium

Financial integration in Panama causes an excess supply or demand for funds to be resolved mainly within the financial sector, by changes

[2]The American invasion triggered widespread looting, with losses of $200 million (3.8

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in the level of net foreign liabilities of banks. Thus, expenditure changes are a low fraction of the absorption needed, and the resulting equilibrating movements of the RER are contained within a narrow range, as experience demonstrates. This process is reinforced by a high elasticity of supply in cyclical sectors, construction and commerce, and an elastic supply of labor that keeps real wages constant. In Robert Mundell's words: "How quickly and easily current accounts adjusted to capital movements; even if the terms of trade or relative price levels change in the direction predicted by classical theory, the changes were . . . small" such that, with capital mobility, "international adjustment . . . becomes much smoother without the necessity of troublesome changes in relative prices, wages, or employment" (Mundell 1997: 34–35).

Panama's experience invalidates one of the main propositions of the open-economy macroeconomic approach—namely, that an excess supply of capital flows will produce an excess demand for goods and a *significant* change in the RER, independently of the exchange rate regime (Corbo and Hernández 1996).[3] When faced with a monetary or real shock, the Panamanian economy adjusts by a combination of two processes: (1) the monetary adjustment postulated by the monetary approach to the balance of payments (Frenkel and Johnson 1976), and (2) changes in expenditures and relative prices (measured by the RER) postulated by the open-economy approach (Jones and Kenen 1985). However, the second process is weaker because the system adjusts automatically, as under the gold standard. Foreign exchange holdings are not needed as reserves, so there is no government borrowing to finance balance of payments deficits or to support the value of the currency, and year-to-year or short-term fluctuations in the balance of payments go unnoticed.

The Function of Banks in Monetary Equilibrium

Under financial integration, banks play an essential role in monetary and balance of payments equilibrium. Adjustment is automatic as a consequence of the budget constraint on expenditures for the economy as a whole, and for banks in particular. As banks are indifferent between dollar transactions abroad or in Panama, their budget constraint is not related to foreign exchange considerations but to their overall balances. As shown by experience, an excess of expenditures

percent of GDP), but commercial activities were almost normal six months later, with no government help, which implies an efficient adjustment process.

[3]The argument for the RER as the equilibrating mechanism assumes full employment, which implies an inelastic supply of factors. In many developing countries, as in Panama, this is not the case.

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over income will change banks' net foreign liability position, and shortly afterwards the banks' constraint on borrowing resources will force an adjustment, implemented by not increasing further their *local* commitments. As a result, expenditures are reduced to a sustainable level.[4] In this type of system there are no excess expenditures financed by bank credit or appreciation of the RER, or overvaluation of assets, as in other countries. The adjustment in financial flows is the relevant variable for monetary analysis and supersedes the adjustment in the stock of money, usually discussed in monetary models.

In Panama's dollarized (i.e., unified) currency system, the quantity of money—currency and deposits held by Panamanians—is demand-determined or endogenous, not supply-determined by the central bank. This is known from several macroeconomic models for the case of fixed exchange rates, especially models following the monetary approach to the balance of payments, which replicates the case of Panama. For financial purposes, Panama is like another U.S. state. Nevertheless, the Federal Reserve does not run Panama's monetary policy or interfere with its sovereignty. Normally, monetary policy is implemented or supported by changes in the money supply, which is endogenous in Panama. The Fed's actions affect Panama via changes in world interest rates, inflation, and credit flows—and only inasmuch as they affect all countries by altering the global supply of dollars (the international reserve currency) or global interest rates.

Financial integration is not achieved by dollarization alone. For example, in the 19th century, there were substantial interest-rate differentials between regions in the United States (Homer and Sylla 1991, Rockoff 1977), which indicates the lack of financial integration. Portfolio adjustment by banks plays an essential role in achieving full financial integration, especially in moving resources out of the country. If there are capital controls, any excess supply of funds can become trapped—because banks cannot invest them abroad, which decouples the internal financial system from the international system. Capital mobility by individuals and firms is necessary for smooth adjustment, but not sufficient. This is confirmed in the case of Hong Kong, which has limited financial integration, exemplified by its differential interest rates, despite having capital mobility. In Hong Kong there are barriers to entry in the banking business, and banks are required to balance separately their Hong Kong dollar and U. S. dollar accounts. In addi-

[4]Changes in banks' net foreign assets serve as an early warning about excess expenditures, facilitating the adjustment process—a case of asymmetric information *improving* the performance of the market.

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tion, banknotes to increase dollar liquidity are exchanged with a small penalty.

In Panama, systemic banking crises do not exist because there are no macroeconomic crises. Bank failures have been isolated incidents, without spillover effects on other banks. This is true even though the regulatory environment was undeveloped, with no deposit insurance and little or no effective reserve requirements,[5] and the government did not assume responsibility for the banks. The presence of major international banks and self-regulation have been effective ways to manage risk. The stability of Panama's banks compares favorably with the experience in Latin America, where losses from financial distress have been between 10 and 40 percent of GDP (Caprio and Klingebiel 1996).

Microeconomic Distortions and Macroeconomic Equilibrium

Until recently, noncompetitive market policies—such as import substitution, controls on agricultural prices, and labor market restrictions—introduced price distortions in Panama (World Bank 1995). Nevertheless, those distortions did not prevent macroeconomic equilibrium in the sense of both internal and external balance brought about by an equilibrium REER.[6] According to Edwards (1989: 9), an internal balance or equilibrium occurs when "the nontradeable goods market clears in the current period and is expected to be in equilibrium in future periods," and when the unemployment rate is at its "natural level." In contrast, an external balance or equilibrium occurs when "the discounted sum of a country's current account" is zero, so that "current account balances [current and future] are compatible with long-run sustainable capital flows."

The stability of Panama's overall economy implies that it satisfies the conditions for macroeconomic equilibrium. Internal and external equilibria are evidenced by a nonaccelerating rate of inflation and sustainable capital flows. This is further substantiated by the absence of macroeconomic crises or overt misalignment of Panama's RER or REER. Furthermore, this macro equilibrium is apparent for real interest rates and asset prices, because market forces without distortions determine the money supply and monetary equilibrium. Although real wages and the RER are outside the competitive equilib-

[5]Deposits in other banks were admissible as reserves. A recent law eliminated reserve requirements and substituted capital-deposit ratios instead.

[6]Sebastian Edwards (1989: 9) defines the equilibrium REER as "that relative price of tradable goods such that, for given sustainable [equilibrium] values of other relevant variables—such as taxes, international prices, and technology—results in the simultaneous attainment of *internal* and *external* equilibrium."

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rium, they have not shown large changes coming from macroeconomic disequilibrium. Panama's microeconomic distortions do not generate macroeconomic disequilibria because they do not influence the constraint on expenditures established by income and sustainable capital flows, and they do not create incentives—via distorted differential returns and prices of financial assets—that have led other countries to overspend, take high risks, and overborrow.

In other countries microeconomic distortions in financial markets have generated macroeconomic disequilibrium. That was the case in Chile from 1979 to 1981, when access to external funds was restricted and international banks were excluded from the domestic market. The markets in dollar-denominated and peso-denominated instruments were segmented, with high interest-rate differentials between them. The large returns from borrowing in dollars and investing in pesos created incentives to borrow abroad and make risky investments locally. The outcome was overborrowing and inefficient risk management by banks and firms, which supported an increase in the price of assets (Moreno-Villalaz 1996).[7] Furthermore, capital inflows, *without financial integration,* endogenized the money supply, which produced an excess supply of money, a high level of foreign exchange reserves, an increase in expenditures, and a high rate of inflation. This caused an appreciation of the RER in Chile (accentuated from the effects of wage indexation and an increase in oil prices), which was a factor in Chile's 1981–82 crisis. Other important factors were the revaluation of the dollar and the decrease in the price of copper.

Mexico had a similar experience in the 1992–94 period, with high interest rates, exclusion of foreign banks, excessive borrowing, increases in the money supply from the monetization of capital inflows, high levels of reserves, inflation, and the appreciation of the peso. In Hong Kong, large capital inflows from 1995 to 1997 resulted in significant increases in asset prices. Financial integration would have diverted the excess supply of money or financial flows abroad, without increasing the local money supply above its equilibrium level. The resulting macroeconomic problem after opening the capital market, therefore, is not one of "too much" capital (Corbo and Hernández 1996) but, rather, one of distortions in the financial system as a result of incomplete financial integration.

Without incorporating financial integration into macroeconomic models, policy decisions are made on the presumption of financial market distortions, which renders them questionable. In many cases

[7]Other authors have a different view. They discuss Chile's banking crisis as resulting from lack of regulation and supervision (see Corbo 1985 and Edwards and Cox-Edwards 1985).

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the arguments behind these policy interventions are implicitly or explicitly market-failure arguments, and have been based, in part, on the notion that the liberalization of capital markets in Latin America was destabilizing (Edwards 1989). However, these inferences are conditioned on the existence of distortions in the financial market, oligopolistic banking organization, and lack of financial integration, which were widespread in Latin America at the time. They are also based on the argument that macroeconomic disequilibrium results from excessive capital inflows, which is not correct, as Panama's experience demonstrates.

False price signals, arising from distorted incentives in financial markets, induce undue risk taking, which later endangers the stability of financial institutions and culminates in a currency crisis—such as in Chile (1982), Japan (1989), Mexico (1994–95), and Asia (1997–1998). The economic literature has emphasized inefficient risk management by banks, a weak regulatory environment, and models based on principal-agent problems, asymmetric information, and moral hazard. The evidence from a financially integrated country like Panama, however, shows that, with no distortions in financial macro-prices (the RER, real interest rate, and asset prices), there is no macroeconomic disequilibrium.

The Ineffectiveness of Government Expenditures to Increase Economic Activity

In Panama an increase in government expenditures cannot increase the level of economic activity in the short run. This is clear if the expenditures are financed internally, due to the crowding-out effect. In addition, at the moment of a crisis, the government cannot borrow abroad either, because it has already committed its borrowing capacity or because it takes time to do so. In fact, government expenditures in Panama declined during economic slowdowns in 1964, 1973, 1983, and 1988–89, while private expenditures were anti-cyclical in 1964 and 1978–80.

If the government borrows funds abroad to cover extra expenditures, there will be an excess supply of dollars to the banking system. Banks will adjust their net foreign liability positions and reduce their external resources (or their foreign investments) by the amount of dollars in excess of their financial needs. Hence, changes in the level of real government debt are compensated for by an opposite movement in the level of real net foreign liabilities and private capital of the banking system. As a consequence, the net flow of financial resources from abroad does not change, compared with what it would have been without the increase in government expenditures. Only the composi-

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tion of capital inflows changes.[8] This was illustrated in 1994–97 when the high liquidity of the Banco Nacional led banks to finance their operations from local resources rather than external resources. It is clear that if the level of capital flows has not changed, neither would the financing of the current account deficit, nor the excess expenditure over income; hence the level of economic activity would also be unchanged. This inference is equivalent to the results of models from the monetary approach to balance of payments, where equilibrium in the monetary sector leaves the stock of money constant, changing only the composition of the central bank portfolio between domestic and external assets (Frenkel and Johnson 1976). The ineffectiveness of fiscal or expenditure policy is contrary to the results of many macroeconomic models (see Jones and Kenen 1985).

Panama's Monetary System as Optimal

Panama's monetary system operates as if it were a competitive market macroeconomy, since monetary equilibrium is the result of private-sector decisions without government intervention or distortions. The system is optimal because of its stability, effective adjustment to shocks, high level of confidence,[9] and absence of distortions in financial macro-prices (i.e., in the RER, real interest rate, and asset prices), which are market determined. More importantly for emerging markets, financial integration generates low interest rates and large capital inflows, and thus higher economic growth.[10] Hence, a systemic solution of the macroeconomic problem, with endogenous or demand-determined money, outperforms a managed monetary and macroeconomic system.[11] Ideal conditions for efficient dollarization are: (1) a large proportion of exports in the reserve currency (such that the effects of changes in its exchange rates are minimized), and (2) diversified and relatively stable income from exports to reinforce the economic stability and avoid the need for abrupt changes in the RER. Many countries fulfill these conditions, with the exception of countries with a large proportion of oil exports.

[8]Nevertheless, banks at their authorized credit ceiling may use the increased funds to expand local operations.

[9]In part, because under dollarization the dollars are in private hands, not in the government central bank.

[10]In addition, lack of financial integration significantly worsens the distribution of income, because financial markets become segmented, which benefits large firms and reduces business opportunities.

[11]In a monetary equilibrium model, with characteristics similar to those of Panama, the optimal money-supply rule found (to minimize perturbations) was to adjust the real money supply to compensate for portfolio adjustment in the demand for money, as if money were demand determined as in Panama (Moreno-Villalaz 1992).

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The operational cost of the Panamanian monetary system, even using the dollar as currency, is lower than the cost of an autonomous system. The cost of the dollarized system has been estimated by the seigniorage and inflation tax paid to the United States (Fischer 1982, 1992; Williamson 1995). But this needs to be compared with the opportunity cost of an autonomous monetary system. Offsetting the seigniorage cost is a reduction in average reserve balances held, which are estimated at 8 percent of GDP, 5 percentage points less than the reserves Panama would need in an autonomous system. The opportunity cost of lower reserves in the dollar system, even if they have zero return, is the same as the opportunity cost of the autonomous monetary system (Moreno-Villalaz 1997, 1998). Besides, there is no cost to maintain a central bank. For a country considering dollarization, part of the currency needed can be provided by foreign exchange kept abroad or in cash form, or could be provided by the reserve currency country, as recommended by Harry Johnson (1972).

The Optimal Exchange Rate Regime

Many economists advocate a flexible exchange rate regime because they consider changes in RERs necessary to respond to external real or monetary shocks (Edwards 1989). In a system with financial integration, however, changes in external flows are largely absorbed within the financial sector, dampening the effect on the money supply, expenditures, and the RER. Thus, the case for a flexible exchange rate regime is weaker than believed, and reflects the absence of efficient market-adjustment mechanisms. A flexible exchange rate is more suitable for countries with large fluctuations in export income or large regions, or where a monetary union is not feasible.

Although the debate over an adequate exchange rate regime has been dominated by problems of currency stability and misalignment, that debate should be redirected in light of Panama's experience. One needs to add financial integration as a goal, so as to achieve low interest rates and nondestabilizing financial flows. Otherwise the monetary system will not be efficient. A unified currency, as in Panama, facilitates financial integration, and for that reason should be considered the preferred system whenever feasible. In that respect a currency board is a close substitute for dollarization (see Hanke and Schuler 1999).

Conclusion

Panama's monetary system, with full financial integration, has shown remarkable economic stability, an ability to handle large capital inflows

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and to adjust to shocks without major disequilibria, and no distortions in macro-prices. It has also shown low interest rates, at levels similar to world market rates, sustained macroeconomic equilibrium, and low operational cost. The economic record contains no policy-induced macroeconomic crisis, no systemic banking crises, and no need for a central bank as a lender of last resort. For nonreserve currency countries, the system performs optimally.

The equilibrating mechanism with financial integration is not the RER. Rather, it is changes in banks' net financial position. Portfolio adjustments by banks play an essential role in achieving full financial integration, capital mobility by individuals and firms being a necessary but not sufficient condition. The stock of money is demand-determined, not supply-determined by a central bank. A unified currency system such as the Panamanian system facilitates financial integration, and for that reason should be considered the preferred system whenever feasible.

Panama's monetary system epitomizes the operation of a competitive market macroeconomy. As such, the lessons derived are useful for other countries, even those with different systems. Policy prescriptions from current macroeconomic models become suspect, including expenditure policies. Also, inferences implicitly conditioned on the existence of distortions in financial markets and macro-prices are subject to question. The proposition that an excess supply of capital flows will produce an excess demand for local goods and a *significant* change in the RER is refuted. Furthermore, it is the lack of financial integration that generates excess capital inflows and an excess supply of money, which, in turn, affect asset prices and lead to appreciation of the RER. The experience of Panama supports a systemic solution to macroeconomic problems over a managed solution (a central bank-based system) and implies that financial integration should occur early in the order of liberalization.

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The Euro: How Important?

Robert Mundell

How important will the euro be in the framework of world international monetary events? It certainly will be as important as anything since the breakup of the Bretton Woods system in 1971 or the movement to floating exchange rates in 1973. But one can make a case that it will be much more important because, in fact, the shift from fixed to flexible exchange rates did not change the configuration of the international monetary system. Before and after that change, the dollar was the major international currency and, if anything, the dollar is more important in the international monetary system today than it was in 1973. One has to go back to the shift from sterling to the dollar, in the period from 1915 to 1974, to find a comparable case. But even then, one could argue that the demise of sterling was not really all that important because by 1914 the United States was already three times as large as the British economy, and it was inevitable that the 20th century was going to be a dollar century and not a sterling century. So one may have to go back to the shift from bimetallism to the gold standard in the 1870s to find a monetary event as important as the launch of the euro.

Features of a Great International Currency

To see how significant the euro is, one has to consider its position as a great international currency. What are the features of great international currencies? There are seven. The first is a large transactions area. The second is a stable monetary policy. Switzerland has a stable monetary policy but a small transaction area, so the Swiss franc could never be a great international currency. Large transactions areas are important because only then do you have a flat, marginal utility schedule for the demand for money, and only then do you get the stability properties of a large system. The third feature is the absence

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Robert Mundell is a Professor of Economics at Columbia University.

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of controls. Of course, no country is absent from controls, and there is always the threat that governments may use political events to establish controls. Gone are the days when George Washington, in the middle of the Revolutionary War, could keep his account at the Bank of England, even though he was the enemy. But the European Monetary Union is going to be very large, and it will have a stable monetary policy. And, at least in the first round, there is no reason why there will be any more controls imposed in Europe than would be the case in the United States. So, with regard to the first three features, the euro stacks up well as a major international currency.

The fourth feature is a strong central state. The United States is a strong central state, Europe is not—and that is a potential weakness. If a country is about to be invaded, its currency will collapse. But Europe is under the U.S. umbrella and the Cold War is over, so the risk that the euro will collapse due to invasion is low.

Fifth, all the great international currencies of the past were initially backed by gold or silver. And that holds also for the dollar. The euro is starting off with no backing whatsoever, except for its market exchange value in the United States and the European Central Bank's commitment to price stability. Nevertheless, members of the monetary union do hold substantial gold reserves (400 million ounces) compared to the United States (250 million ounces), representing 40 percent of the world's gold reserves, and members have foreign exchange reserves (of about $450) that are three to four times as large as U.S. reserves—all of which give the euro some fallback value.

The sixth factor is a sense of permanence. You have to have a belief that the euro is going to be here not just tomorrow and 10 years from now, or 30 years from now, but 100 years from now. It has to have that sense of permanence, otherwise no one will want to hold euros or euro bonds.

That leads us to the seventh feature, low interest rates, which are always associated with great international currencies. If one looks back at different currency areas, one would see that there was never a single currency that dominated everything. In the ancient world, there were the Roman, Greek, and Egyptian currency areas, each with its own unit of account. And, in the Middle Ages, there was the Islamic currency area, the Pagan area, and the Christian area in Central Europe. In the 19th century, from 1873 to 1914, there was a gold bloc, a silver bloc, and a bloc of paper currencies. In the future, I predict there will be a dollar bloc, a euro bloc, and a yen bloc.

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Liquidity Effects and the Value of the Euro

The euro will have a number of liquidity effects that are going to affect its value. The first two will be inflationary, the last four will be deflationary.

First, the mere act of replacing national currencies with euros will make the euro more liquid than the national currencies. So there will be an inflationary factor. Second, there will be an increase in the money multiplier as members of the monetary union try to profit by creating substitutes for the euro and expanding credit. That too will be inflationary. Third, there will be excess reserves because pooling reserves of member countries will give European central banks more gold and foreign exchange than they need. This will create an urge for expansion. The head of the previous government in Italy already said, "Let's spend some of those excess reserves on solving the unemployment problem," which is not good news for Europe.

Fourth is the "exorbitant privilege" argument, which is reminiscent of Charles DeGaulle's argument in the 1960s that the United States can go out and spend and pay for its imports with dollars, which people could then hold and use as money. That arrangement gave the United States an exorbitant privilege and free interest-bearing loans, or what was called "a deficit without tears." Europe will now be in a similar situation with respect to the euro.

The fifth factor, foreign demand for euros, will be deflationary, as will the sixth, diversification from dollars into euros.

The Future of the Euro as a Reserve Currency

My projections of the future demands for reserves are as follows. Today world GDP at current exchange rates is about $30 trillion, with the United States at $9 trillion, the European Union at $9 trillion, and all other countries at $12 trillion. By the year 2010, GDP is projected to be $60 trillion, with the United States at $18 trillion, the European Union at $18 trillion, and all other countries at $24 trillion. Foreign exchange reserves are about $1.2 trillion held in dollars and about $0.4 trillion held in other currencies. Leaving aside gold, that makes a total of $1.6 trillion in foreign exchange reserves. By 2010, those reserves will grow to approximately $3.2 trillion.

Reserves double every 10 to 12 years. They have in the past and they will again. The demand for dollars in 2010 will be about the same. The demand for euros will be about the same as the demand for dollars. If true, then in 2010 world foreign exchange reserves will consist of $1.2 trillion in dollars, $1.2 trillion in euros, and $0.8 trillion in other currencies. That means U.S. dollar reserves would not grow

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in the next 10 years, while euro reserves would grow by about $100 billion a year, which would have a big impact on trade balances, if not offset by compensating capital movements. Even if there is no diversification, if nobody sells dollars, but just holds them, there will be a shift into euros and other currencies.

Conclusion

The euro area: How big will it be? My own prediction is that by the year 2002 the European monetary Union will include its current 11 members plus Greece (which is already committed to join), Sweden, Denmark, and Britain. By 2005, Slovenia, the Czech Republic, Poland, Hungary, and Estonia will also be in. And by 2010, assuming all goes well and the monetary union is prosperous, no country in Europe will want to, or be able to, afford to stay out. Thus, Slovakia, Croatia, Lithuania, Latvia, Romania, and Bulgaria will all join the monetary union.

The dollar-euro exchange rate is going to become the most important price in the world, and neither Europe nor the United States is going to want to have big fluctuations in that price. My own belief is that there will be a movement toward stabilization, institutional or otherwise, de facto, to stabilize and reduce fluctuations. When that happens, Japan will not want to let its exchange rate diverge very much from the dollar-euro rate, so that by 2010 we will be back to a world where we get more fixed exchange rates, and the International Monetary Fund will be dragged back to its original function.

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The Impending Collapse of the European Monetary Union

Charles W. Calomiris

European monetary union will centralize control over European currency. Some have argued that the scale of this new currency area will cause a leap in demand for European currency as a numeraire and store of value. Furthermore, reductions in transactions and hedging costs from currency homogeneity within Europe could increase European wealth and income.

It is argued that this change would be beneficial to the world economy, not just to Europe. Giving other countries the ability to peg their currencies to a basket of hard currencies (say, a mix of the dollar and the euro), rather than just to the dollar, might stabilize fixed exchange rate regimes. For example, pegging to a bundle of currencies could take the form of a currency board that redeems a fixed bundle of "hard" currencies in exchange for the domestic one. A bundle of currencies is potentially superior as an anchor because its value is more stable. A productivity shock in the United States that produces a real exchange rate appreciation for the dollar won't produce as large an imbalance with emerging market countries if the hard-currency bundle includes the currencies of countries other than the United States which are not experiencing that productivity shock. So a stable European currency could contribute to overall financial stability.

Furthermore, the introduction of the euro could produce a one-time depreciation of the dollar, which immediately could take some pressure off emerging market countries pegged to the dollar.

The Problem of Credibility

Is this rosy scenario plausible? It depends on whether Europe will produce, or be expected to produce, a truly "hard" currency to com-

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Charles W. Calomiris is the Paul M. Montrone Professor of Finance and Economics at Columbia Business School and Co-Director of the American Enterprise Institute Project on Financial Deregulation.

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pete with the dollar as a numeraire and a store of value, within and outside Europe. The fiasco produced by France over the management of the new central bank, and the willingness of the Germans to cede to those demands, raises strong doubts about any immediate use of the euro as a competing international store of value. The long-run prospects for the euro to become a hard currency are unclear, and I am rather pessimistic, both because of the apparent weakness of Germany in opposing French pushiness, and because credible policy rules to insulate the euro from fiscal shocks in member countries have not been laid out, and likely will not be in the future.

Euro-optimists should bear in mind that currency unions not only can begin, but also can collapse. The United States (a currency union mandated by its Constitution, and defensible by force of arms, if necessary) is the successful historical exception among history's attempts to create a common numeraire from a variety of local ones. Unlike the case of the United States, European members of the monetary union will retain the option to exit. That not only means that the monetary union may fall apart; it also means that the (implicit or explicit) threat of exit will be used by member countries to influence monetary policy, and thus keep the currency from becoming a reliable international anchor.

My concerns about member countries' meddling into central bank policy go beyond the occasional fudging of medium-run targets because of differences in unemployment rates across countries. I am concerned primarily about the absence of credible constraints that would limit the long-run monetization of deficits, and the way cross-country differences in the taste for the long-run level of inflation will undermine the currency union.

Structural Weaknesses

As the rules currently stand, there remains some uncertainty regarding the amounts of each country's government securities that will be purchased by the central bank, and the formula for how the seignorage (the profits from holding those securities) will be distributed among member countries. Let's assume (as is likely) that securities will be purchased and revenues will be shared on an equal (proportionate to GDP) basis.

This arrangement leaves a lot of room for inflationary mischief resulting from the monetization of deficits. Monetary union will encourage countries whose tastes lean more toward monetizing deficits to press harder for monetization. Soft-money members will recognize that the costs to inflating are now lower because their neighbors are

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also forced to inflate alongside them. Inflation will no longer be one of the competitive tools used by governments to compete in attracting multinational enterprises. Why will hard-money members agree to inflate? The threat of exit by soft-money countries will be used successfully (for a time) to gain acquiescence by hard-money members of the union for higher inflation.

The amount of deficit monetization that is likely to occur in the future is greater than one would estimate from current levels of European deficits, for three reasons. First, because monetary union will reduce the costs to a fiscally irresponsible government of monetizing its deficit, monetary union will encourage larger deficits in the future.

Second, running larger deficits increases the bargaining power over inflationary policy of soft-money countries by making their exit threats more credible. Soft-money countries can use large deficits to bolster their threats to exit—pointing to the possibility that they will "have to" exit from the European Monetary Union to monetize those deficits unilaterally unless hard-money countries agree to joint monetization. The threat of exit is more credible if a member country's present value of tax revenues net of expenditures (which, they will argue, are constrained by domestic politics) is inadequate to repay its future debt service costs. Thus running higher deficits makes the threat of exit more credible, and makes it easier for soft-money countries to push for monetization.

Third, large contingent liabilities of soft-money members are already looming on the horizon. What expenditures are most likely to produce the enormous fiscal deficits that will weaken, and ultimately undermine, the euro? The two most important categories of off–balance sheet fiscal risk are pension systems and banking systems.

As Jonathan Gruber and David Wise (1998) show, the pension systems of some of Europe's economic giants are heading for disaster in the not-too-distant future. High retirement benefits are encouraging declining labor participation, which is adding to the fiscal problems the pension funds face. The unused labor capacity of workers between the ages of 55 and 65 is 67 percent in Belgium, 60 percent in France, 59 percent in Italy, and 58 percent in Netherlands, compared to 48 percent in Germany and 37 percent in the United States. The potential for a massive fiscal expenditure to bail out insolvent pension systems poses a severe threat, and the threat is larger in some countries than in others.

Potential bank bailouts are another source of large deficits. Here, too, Italy and France are among the most vulnerable. The banking sectors of France and Italy are among the weakest in Europe, and

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they will come under increasing pressure from the competing Dutch, Spanish, German, and British banks. Large and growing bank bailouts (following the examples of Credit Lyonnais and Banco di Napoli) are a distinct possibility over the next few years.

Thus, big declines in the euro against the dollar, and the eventual collapse of the euro, will most likely coincide with ballooning fiscal problems from off–balance sheet government liabilities, not changes in on–balance sheet taxation and expenditure which receive so much attention from many macroeconomists and the press. The need to redefine fundamentals to include off–balance sheet fiscal risks is one of the primary lessons of the exchange rate collapses in Asia, Mexico, and many other countries over the past two decades. It is a lesson that remains to be learned in Europe (and by some influential macroeconomists in the United States, as discussed in Calomiris 1998).

Eventually, one or more hard-money members will tire of suffering the costs of inflation. The intolerance for continuing inflation in the hard-money members will lead them to exit the system. While the (implicit or explicit) threats to exit will come mainly from soft-money members in the early years of the European Monetary Union, it will ultimately be the hard-money members who force its dissolution.

Can Reform Help?

Can anything be done to address the structural weaknesses I have described? Realistically, probably not much. I can imagine three reforms that could conceivably help to forestall problems, and make it more likely that the euro would become a hard currency—but two of these possible reforms are very unlikely, and the third is positively far-fetched. The unlikely ones are (1) implementing immediate credible solutions to pension system insolvency and (2) bringing market discipline into Europe's banking regulation. Market discipline would require, minimally, a credible subordinated debt requirement as a part of bank capital standards. (For details, see Calomiris 1997). Weak banks, of course, do not like the idea of market discipline, so this is not a policy likely to be greeted enthusiastically by Europe's powerful bankers. And the anticipated cross-subsidization coming from monetary union removes the incentives of the fiscally weak to undertake the costly process of banking or pension reform.

The third (and most far-fetched) reform would be to implement credible rules for open market operations and seignorage sharing that would discourage fiscal profligacy and the monetization of deficits by the union. It would be logically feasible (see the appendix for details) to set a rule that would link the fiscal risk created by a member

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country to its share of seignorage from the euro. That is, suppose that higher fiscal risk (defined as an increased possibility that future taxes will not pay future government debt service costs) led automatically to a dumping of some portion of that government's bonds by the central bank, and a reduced share for that country in the seignorage created by the central bank. It is even conceivable that the creation of fiscal risk could be penalized by fees in addition to losses of seignorage revenue.

Such a rule might discourage fiscal profligacy and thereby make deficits, and their monetization, less likely. But this proposed rule for sharing seignorage and penalizing fiscal risk, while interesting to think about and possibly effective in principle, is politically almost unimaginable. The conflicting goals of the governments within the union, and the weak political will of Germany to demand concessions from France and others, would be an insurmountable hurdle to imposing a rule for "incentivized" seignorage sharing (especially since such a rule would require amending the Maastricht agreement). The union would be very unlikely to establish a rule that would discourage soft-money countries from running deficits, or to enforce such a rule if somehow it were established.

Conclusion

I predict that the euro will be a weak currency (one that will not retain its value against the dollar), and that it will not be a permanent currency. Ultimately, the euro will most likely be remembered neither as a textbook example of the social gains of properly defining the optimal currency area nor as the harbinger of global exchange rate stability, but rather as an illustration of the importance of fiscal discipline for monetary credibility, and as a monetary example of the tragedy of the commons.

European union will likely strengthen the attraction of the dollar as a numeraire and a store of value. Countries outside of Europe will continue to peg their exchange rates to the dollar. And when the European Monetary Union ultimately collapses, it will itself provide a positive shock to the real dollar exchange rate that will hurt countries that have pegged to the dollar. All of this is unfortunate from the standpoint of global macroeconomic stability—an example of how political constraints that limit rational policy and encourage public profligacy make the global economy less stable than it otherwise would be.

What could Europe do to promote its own interests and improve global financial market efficiency? Rather than focus on risky attempts

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at reforming monetary policy—ironically, an area where there is probably relatively little to be gained from reform—more emphasis should be placed on a fundamental redesigning of Europe's inefficient core institutions of commercial law, corporate governance, and banking. Reforms that would strengthen the rights of shareholders and debtholders (including bankruptcy reforms) should be a top priority. Here France and Italy especially have much to learn from Great Britain (for details see La Porta et al. 1997). Allowing European-based companies to choose which country's securities, banking, and commercial laws apply to them (a proposal akin to Romano's [1998] recent proposal for promoting regulatory competition within the United States) would be a wonderful first step toward spurring the reform of core economic institutions. That kind of economic integration would really make a difference for Europe, and provide an example of the constructive role of institution building to be imitated by emerging market countries.

Appendix

This appendix outlines a means for limiting the risk of deficit monetization within a monetary union by linking the seignorage earned by a member country to the amount of fiscal risk it creates.

Fiscal "insolvency" risk for a member country is defined as the probability that the member country will be unable to meet future debt service obligations from its net future taxes and "normal seignorage" (the amount earned if all members follow a noninflationary monetary policy rule).

A member that is perceived as fiscally insolvent must either change its tax and expenditure policies to become fiscally solvent, exit the monetary union and inflate unilaterally (raise new inflation taxes from unilateral seignorage), or remain in the monetary union by convincing other countries to jointly inflate.

Assume that with probability p an insolvent member will be able to convince other members to jointly inflate (through higher euro money growth) in order to keep it in the union.

Initially, at the onset of the monetary union assume that all countries are fiscally solvent. The objective is to make countries react to an initial deficit shock with an increase in direct taxation by penalizing a member country (through a reduction in seignorage share from operating the European Central Bank, and possibly an additional fee) if it does not respond to a deficit shock with sufficient taxation.

This policy will only work for some, perhaps unrealistic, parameter values. If initial p is large (sufficiently close to 1) the rule will be useless, since ultimately the coalition will likely absorb members'

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deficits. But if a member's p is sufficiently small initially, if the first derivative of p with respect to that country's deficits is not too large and positive, if fiscal imbalances develop sufficiently slowly and persistently over time (so that the costs of current forgone seignorage are large compared to the gains of future monetization), and if feasible penalties can be sufficiently large, then the cost imposed on members that increase fiscal risk could provide adequate incentives to limit fiscal risk.

How will fiscal risk be measured, and how will seignorage shares be reduced (or fees assessed) as a function of that risk? One simple approach would be to use market measures of fiscal risk as a basis for varying seignorage shares and penalties. For example, in a two-country model (for simplicity) where penalties are limited only to lost seignorage, the seignorage share of country 1 (bounded by zero and one, and equal to one minus the seignorage share of country 2) would be a function of the relative yields of 30-year "legal tender" bonds issued by the two countries. As the relative bond yield of a country rises, its seignorage share falls. If additional penalties are feasible, that implies that the feasible range of seignorage shares would include negative values.

"Legal tender bonds" rather than euro-denominated bonds would be used here to measure fiscal risk because doing so would maximize the responsiveness of market yields to market perceptions of fiscal risk. All member countries would be required to issue a fixed percentage (say, 10 percent) of their government debt in the form of legal tender bonds. A legal tender bond has the following structure: it pays in whatever currency is the legal tender of the country at the time of the delivery of the bond coupon or principal payment. If the country switches from the euro to some other currency at some point in the future, *all* future bond payments would be converted into that currency at the currency conversion ratio prevailing *at the time of the currency change*. Thus bond payments would *not* be indexed. If a member country exited the system in order to inflate its currency (after suffering a fiscal insolvency and being unable to convince other members to monetize it within the currency union), then the real value of the promised payments on the bond would fall. For a discussion of the use of legal tender bonds in United States history, see Garber (1986) and Calomiris (1991).

That structure ensures that the ex ante yield on the bond will provide information about market perceptions of the member country's fiscal affairs. Of course, this plan can work only if there is a sufficiently large probability that soft-money countries will be forced to exit the monetary union. Yields on these bonds would not reflect fiscal risk

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if $p = 1$, since in that case countries would never have to exit as the result of insolvency.

The usefulness of simple yield differentials to provide information about the relative fiscal risks of countries requires that countries suffer similar risks of being forced to exit the monetary union as the result of fiscal insolvency. For example, if the union were more likely to bail out France than to bail out Spain, then French yields would rise less than Spanish yields for any given change in fiscal risk. Thus a seignorage sharing rule that treats all countries equally may unfairly discriminate against smaller countries (whose bargaining power is weaker because their membership is not vital to the perpetuation of the union).

As noted in the text, in practice this plan is far-fetched. Initial values of p may be too large (at least for some countries—like France and Italy) to make seignorage penalties effective deterrents. Second, the rule is unlikely to pass, since some countries would probably oppose it. Germany and Netherlands would gain from its passage more than others, while France and Italy might lose on net if the rule were passed. Furthermore, it is hard to construct rules that ensure enforcement by the central bank (one should not underestimate the creativity of bureaucrats when defining the meaning of inconvenient statutes).

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Is Inflation Too Low?

William Poole

What is today's big monetary policy issue? It is, surely, the extraordinary volatility of the financial markets and the wide quality spreads that opened up between riskier bonds and Treasury bonds following the Russian default in mid-August 1998. No one forecast these problems; the financial-market upset certainly was not a real, live policy issue back in the spring and early summer.

We should not underestimate the magnitude of the current disturbance in the U.S. financial system. Monetary policy today is, I believe, appropriately focused on dealing with the possible effects of the financial-market disturbance on the U.S. economy. The size of that disturbance and the circumstances surrounding it are so unusual in the context of U.S. history that policymakers must concentrate on dealing with this situation for the time being.

The financial upset, however, will disappear from the radar screen of pressing policy issues as the markets settle down in due time. All of us will then return or should return—to analyzing longer-run issues. With regard to the current outlook, I will say only that I am optimistic that we will work through current problems, painful as they have been for many, with no significant damage to the U.S. economy. My optimism stems from the economy's strong initial conditions of low inflation, low and stable inflation expectations, and a well-capitalized banking system. These are about as favorable a set of initial conditions as one can imagine for getting through financial turmoil with minimal effect on the real side of the economy.

The issue I wish to explore is this: Is zero inflation, abstracting from measurement error in the broad price indexes, too low? I think

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William Poole is President and Chief Executive Officier of the Federal Reserve Bank of St. Louis. The views expressed in this article are solely those of the author and do not necessarily reflect official positions of the Federal Reserve System. The author thanks the St. Louis Fed Research Department, especially David Wheelock, Jim Bullard, and Joe Ritter, for assistance in preparing this paper. The usual caveat applies.

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zero is a very nice number, especially when it comes to inflation. But there is a serious argument that the economy is likely to work better with a moderate inflation of, say, 2 or 3 percent per year. I disagree with that argument.

I will concentrate on two arguments for moderate inflation. The first argument holds that inflation facilitates the smooth operation of labor markets and thereby promotes maximum employment in the face of nominal wage rigidity. The second argument contends that inflation, via the Fisher relationship, keeps nominal interest rates from falling too close to the zero bound, and thereby gives the Fed sufficient room to ease—that is, to cut rates—should a recession appear imminent.

In my view, both arguments are wrong. I will begin by outlining some reasons why I believe that zero inflation should be the paramount objective of monetary policy.

The Case for Zero Inflation

As Chairman Alan Greenspan has pointed out on numerous occasions, our economy's fine performance since the early 1990s was accompanied initially by declining inflation and, more recently, by low and stable inflation. Clearly, the U.S. experience of the last five years casts doubt on the old claim that falling inflation will inevitably bring slower real growth or a higher rate of unemployment. This experience also suggests that reducing the variability of inflation need not increase the variability of output, as some people argue.

Although the performance of other countries with low inflation is somewhat mixed, my point is simply that there is little evidence to suggest that zero inflation necessarily implies slow real growth. Indeed, Robert Barro (1996) and others have reported systematic evidence to the contrary. Certainly, there are good reasons to expect that a zero-inflation monetary regime, sustained over the long run, would enhance an economy's performance.

If the monetary authority is credibly committed to zero inflation, then one source of interference with the efficient working of markets—uncertainty about expected inflation—would be reduced. Inflation uncertainty makes it difficult for individuals and firms to distinguish changes in relative prices among goods and services from movement in the aggregate price level. Mistakes in the allocation of resources are more likely to occur because of this uncertainty, with real growth consequently less than it could be.

By confusing the meaning of individual price changes, inflation uncertainty also raises uncertainty about the prospects of investment

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returns. A rising rate of inflation can lead both borrowers and lenders to be overly optimistic about likely returns, resulting in inefficient resource commitment. If the price expectations that are assumed when funds are committed are not realized, borrowers may encounter difficulty repaying their debts, which in turn puts stress on lenders. Thus, it is reasonable to expect that eliminating uncertainty about the rate of inflation will enhance, although obviously not guarantee, financial stability.

Presumably, to eliminate uncertainty, the rate of inflation need not be zero, but simply predictable. For at least two reasons, however, I believe zero should be the target. First, maintaining a steady but positive inflation rate would probably be harder politically than maintaining a steady zero inflation. The reason is that we live in a world where both politicians and economists often argue that just a little more inflation would generate positive real economic gains. If we accept the argument that 2 percent inflation is okay, why not 2.5 percent? Let me emphasize that when I advocate zero inflation, I am ignoring measurement questions, such as whether or not bias exists in the relevant price index. As a practical matter, policy is probably best specified in terms of a measured inflation range that accounts for our best estimate of measurement errors.

A second reason I advocate zero inflation concerns the distortions caused by the interaction of inflation with the tax code. Inflation indexing is incomplete, especially for investment income, because nominal interest income and nominal capital gains are subject to tax. Martin Feldstein (1997) has estimated that reducing inflation from its current level of about 2 percent to zero would yield substantial, permanent real income gains. Theoretical analysis by James Bullard and Steven Russell (1997), and others, also suggests that tax distortions cost the economy substantial real performance at higher rates of inflation.

In short, I think the case is strong that monetary policy should aim for zero inflation as its paramount objective. Moreover, I reject the approach that zero inflation must be shown to be superior to a poorly specified alternative of "some" positive inflation. The burden of proof really should fall on those who contend that positive inflation is better. So, let me now consider the arguments advanced for a positive rate of inflation.

Labor Market Arguments

One perennial argument in favor of positive inflation is that certain wages must fall relative to other prices or other wages, and inflation

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allows this adjustment of real wages to occur in the face of nominal wage rigidity. The centerpiece of this argument is the claim that downward nominal wage adjustments occur too infrequently to be consistent with flexible real wages in a world where microeconomic shocks continuously alter the relative positions of particular firms, industries, or occupations. With zero inflation, the argument goes, rigid nominal wages prevent optimal adjustment to relative price disturbances with the result that employment varies inefficiently. Therefore, a little inflation is a good thing because it allows wages to fall relative to other prices; inflation "greases the wheels" of labor-market adjustment.

Zero Inflation in a Different Regime

There are, in my opinion, serious flaws at three levels of this argument. First, the argument claims that nominal rigidity creates a large inefficiency that inflation ameliorates. But, if the claim of a large inefficiency is true (and I will question it later), a simple theoretical argument creates the presumption that nominal wages would not continue to be sticky in a zero-inflation regime.

There is some dispute about the extent to which nominal wages are downwardly rigid. But, no doubt some employers have found it difficult to reduce nominal wages during the periods covered by the most popular data sources. One data source, the Panel Study of Income Dynamics, started in the late 1960s. I mention the sample period because making an empirical regularity the foundation, rather than an implication, of economic theory is always dangerous. Robert Lucas (1976) elegantly demonstrated this point more than 20 years ago. To the extent that downward nominal wage rigidity exists, it presumably serves some economic function. After all, putting minimum wage laws aside, fixed nominal wages are not required by law. We cannot assume that the present degree of wage rigidity—whatever it is—would continue into a different inflation regime. Indeed, a compelling case can be made that the extent of wage rigidity we observe would not survive in a zero-inflation regime.

Consider an environment where, broadly speaking, the annual changes in broad price indexes are usually close to zero and have been for some time. Suppose also that the Fed's commitment to maintaining this regime is clear. In such an environment, nominal wage rigidity, according to the "grease the wheels" argument, would generate a large inefficiency that inflation—now zero—would no longer ameliorate. This inefficiency, however, is exactly what should make us doubt that nominal wage rigidity would continue to exist. The main function of the price system is to allocate resources by setting

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relative prices. Competitive forces would likely eliminate anything that interferes with relative price adjustment, particularly if failure to adjust is very costly, unless there is some compelling reason for it to exist. Could we imagine that nominal wage rigidity would continue during a sustained 10 percent deflation? Of course not. Why? The private costs of interfering with relative price adjustment would be too high. It may take longer for competitive forces to erode nominal rigidity under zero inflation, but the principle is the same.

Keep in mind that the magnitude of ongoing resource reallocation in U.S. labor markets dwarfs the employment growth that makes headlines on the first Friday of every month. Jobs appear, jobs disappear, and people move into and out of them at rates far higher than net employment growth. This is prima facie evidence that U.S. labor markets do not suffer from any massive inefficiency.

If nominal wage rigidity creates significant economic inefficiency, it seems entirely plausible that it is perpetuated by inflation. I admit I do not know for sure. However, based on the current state of economic theory, I think we must favor the presumption that inefficient wage rigidity would disappear in a zero-inflation economy. This position makes sense if we take economic theory seriously.

Other Mechanisms for Relative Wage Adjustment

A second flaw in the "grease the wheels" argument is that it imagines only two mechanisms for achieving adjustments to a worker's relative wage: Either cut the nominal wage, or let all other prices around it rise. In fact, the workings of labor markets suggest at least two other mechanisms, and so the presence of nominal wage rigidity—were it to exist—might not be a hindrance in a zero-inflation world.

First, average compensation tends to rise over time, as overall productivity improves. Thus, in a zero-inflation environment, nominal wages may not need to fall, even in some declining occupations. Proponents of the "grease the wheels" view sometimes ignore this mechanism.

Internal labor markets provide yet another adjustment mechanism. Compensation tends to increase with seniority, partly because of an individual's accumulation of human capital. Edward Lazear (1981) has argued that an upward-sloping path for earnings also acts as a mechanism to overcome agency problems within the firm. James Malcomson (1984) and others have argued that promotions may play a similar role; rather than simply filling positions necessary for the technological operation of the firm, promotions provide necessary incentives for those at lower levels of the hierarchy.

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The common theme in these observations about internal labor markets is that an individual worker will typically expect an increasing real wage. Therefore, the kind of base adjustment achieved by inflation can also be accomplished by delaying wage change relative to an individual's upward-sloping real wage path.

Of course, there is a segment of the labor market where little human capital accumulation exists and long-term implicit contracts are rare. But, for obvious reasons, this is exactly the segment where turnover costs are low on both the supply and demand sides of the market. Hence, any nominal wage rigidity that is present is not especially costly.

Inflation and Relative Price Variability Are Linked

The third flaw in the labor-market case for positive inflation is perhaps the most transparent. Inflation tends to increase the sort of microeconomic shocks—because cross-sectional variation in price changes tends to rise with higher aggregate inflation—that underlay the case for pursuing a positive rate of inflation. Thus, the claim that inflation helps the economy cope efficiently with relative price changes is immediately suspect, since there is more relative price variation to cope with if there is more inflation.

Labor Market Costs as Well as Benefits

Overall, I believe that the benefits of inflation as labor market "grease" are exaggerated. Furthermore, inflation itself seems to worsen the problem it ostensibly alleviates. In addition to these theoretical arguments, we now have some direct evidence, supplied by Erica Groshen and Mark Schweitzer (1996, 1999). They recognize that compensation is typically set for at least a year, and that there are, in essence, two pieces to a firm's wage-setting process. First, management decides on the overall change in the wage pool, based in part on the rate of inflation expected to prevail over the following year. This wage pool, in effect, sets the firmwide budget constraint. Second, individual wages and salaries are adjusted in a way that satisfies the budget constraint. This two-step process is explicit in many organizations.

Mistakes occur in the first stage when managers misforecast inflation. "Sand in the wheels" effects occur if higher average levels of inflation result in more inflation variability, causing larger inflation forecasting errors. A consequence is that inflation will cause more interfirm variation in wage adjustment. "Grease" effects operate as I outlined earlier and imply more dispersion of interoccupational wage adjustment. The "grease" effects should taper off as inflation rises

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because some level of inflation enables employers to make all of the relative wage adjustments they would make in a frictionless labor market. Because they view wage setting as a two-stage process, Groshen and Schweitzer estimate the "grease" and "sand" effects separately. They find evidence of both effects, with "sand" effects rising rapidly with the inflation rate. Comparing the "grease" and "sand" effects directly, Groshen and Schweitzer find that even for low inflation rates the net benefit of inflation is statistically indistinguishable from zero, although point estimates of the gross benefit do slightly exceed estimates of gross cost.

One might quibble with the specifics of their empirical strategy, but Groshen and Schweitzer's emphasis on evaluating costs as well as benefits is absolutely correct. From the standpoint of labor markets, I think it is fair to say that the evidence of net benefits from an inflationary monetary policy is slim to none.

The Zero Nominal Interest Rate Boundary

Now let us consider whether concerns about conducting countercyclical monetary policy in a low-inflation environment can justify a positive rate of inflation. Specifically, does price level stability cause special problems for monetary policy because nominal interest rates cannot be less than zero?

The zero-bound view is an old and much debated one in macroeconomics. With rising inflation in the 1970s and early 1980s, the issue largely became moot, as policymakers scrambled to get inflation back under control and to regain lost credibility. Recently, however, the topic has resurfaced as inflation rates in the industrialized countries have fallen and stayed low during the 1990s, and as central banks around the world have adopted inflation targeting as a method of achieving and committing to price stability.

The zero-bound view holds that moderate inflation aids in the implementation of stabilization policy by keeping nominal interest rates from falling "too" low. The bottom line, according to this argument, is that an inflation target of zero interferes with the attempts of monetary policymakers to stimulate an economy in recession because the nominal interest rate obviously cannot fall below zero. Put another way, with moderate ongoing inflation the policymakers have room to push the real rate of interest below zero, which they cannot do when the steady inflation rate is zero.

The zero-bound story begins with the commonplace idea that monetary policy is concerned with setting a short-term nominal interest rate—in the United States, the nominal federal funds rate. A higher

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nominal federal funds rate is often described as a tighter policy, while a lower nominal federal funds rate is described as an easier policy. When the economy is weak, the monetary authorities lower the nominal federal funds target in an effort to stimulate interest-rate-sensitive sectors of the economy. So according to this view, when a recession hits, the current level of the federal funds rate determines the number of basis points the Fed has available to combat the recession. The lower the initial funds rate, the less scope for subsequent easing. As you might guess, I dislike this characterization of monetary policy, but let me finish the story.

Of course, financial market participants are interested mainly in the real interest rate, not the nominal interest rate. A simple Fisherian decomposition divides any nominal interest rate (with zero default risk) into two major components—a real component determined by equilibrium conditions in the economy and a nominal component determined by the expected inflation rate.

The zero-bound view holds that the expected inflation component of nominal interest rates moves little over periods as long as a year, so that adjustments in the nominal federal funds rate mainly change real returns at the very short end of the term structure. Movements in short-term rates then lead to adjustments in longer-term real interest rates.

What hampers stabilization policy in a low-inflation environment, according to the zero-bound view? If inflation is zero and expected to remain that way, then the expected inflation component of nominal interest rates is zero, and the nominal rate is lower on average than it would be in a world of persistent inflation. Thus, in a recession, the Fed would have less room to cut interest rates because of the zero nominal bound. The end result, according to this view, is a longer and deeper recession than would otherwise be the case. The message is clear: If the Fed is to help the economy in times of distress, nominal interest rates must be kept high enough in normal times, which requires maintaining a modest rate of inflation.

The zero-bound view has raised many counterarguments over the years. Perhaps most obviously, the view places heavy emphasis on the idea that monetary policy can be used to fine-tune the macroeconomy, downplaying well-known concerns that attempts to fine-tune can contribute to economic instability. Leaving that issue aside, however, there are still several reasons to doubt the validity of the zero-bound argument for pursuing a policy of positive inflation.

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Monetary Policy Is Fundamentally Not About Nominal Interest Rates

First, we must remember that nominal interest rates do not indicate the true stance of monetary policy even though, as a practical matter, the Fed implements short-term policy by targeting the nominal federal funds rate. This method of implementation has been effective in recent years. Controlling the funds rate is not, however, an end in itself. Fundamentally, monetary policy is reflected in the growth of the money stock and, ultimately, the rate of inflation. So the idea that central bankers are somehow trapped if the nominal short-term interest rate nears zero seems quite a stretch to me. We are in the business of providing liquidity to the macroeconomy, and if the situation calls for it, liquidity can always be injected, regardless of the level of nominal interest rates.

The first years of the Great Depression offer perhaps the clearest illustration that monetary policy is fundamentally about providing liquidity and not about controlling nominal interest rates. During that time, nominal interest rates were low, which seemed to indicate an "easy" monetary policy. But as Milton Friedman and Anna Schwartz (1963) have noted, from 1930 to 1933 the money stock was falling rapidly, indicating a far tighter policy than was intended. Of course, that policy was an unmitigated disaster, as both output and prices fell by a third and the unemployment rate hit 25 percent. That experience, as well as other, less dramatic historical episodes, should make it obvious that blind adherence to nominal interest rates as indicators of the stance of monetary policy can be tragically misleading.

We might also do well to remember that during the late 1950s and early 1960s, the nominal annualized yield on three-month Treasury bills fluctuated around 3 percent, while the yield on 10-year Treasury bonds was around 4 percent. These yields are below, but in the general ballpark, of those we observe today. Consumer price index inflation during that period averaged about 2 percent on a year-over-year basis—not too different from today's inflation rate. So, while we have not seen a sustained zero-inflation environment in the United States during the postwar era, we have seen an environment not too different from today's in terms of relatively low inflation. And during the late 1950s and early 1960s, there was no obvious impediment to the operation of monetary policy just because inflation was low.

Inflation and Output Variability

The relative stability of our economy in recent years suggests that low inflation probably contributes both to less inflation variability and to less output variability. Over the 1970s and early 1980s, by contrast,

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when inflation rose sharply and then fell abruptly, the United States suffered through three recessions, including two of the most severe recessions of the postwar era. To be sure, during that period, the U.S. economy was hit with shocks from external sources, but at the same time monetary policy was decidedly uneven—resulting in a substantial inflation that both caused unnecessary distortions and proved difficult to tame. Thus, the postwar experience strongly suggests that lower inflation is associated with less volatile inflation, and lower inflation volatility is reflected in lower volatility in real output. Even in a zero-inflation environment the lower bound on nominal interest rates would probably not be a problem for stabilization policy because economic volatility itself would likely be lower.

Nonlinear Effects near Zero

A final reason to doubt that monetary policy would run aground in a zero-inflation world stems from the nonlinearity of investment demand. This nonlinearity implies that a given interest rate change, measured in basis points, may well have a larger impact when interest rates are low than when they are high.

Much of the thinking behind the zero-bound view is centered on the extrapolation of linear effects to very low interest rate environments. In much of the work on this issue, the average effects of short-run monetary policy changes are estimated using postwar data, which include many years of high inflation. There is little reason to think that coefficients estimated from an environment of relatively high inflation would be good proxies for the coefficients in the new circumstance.

We might expect that a given basis points change in the nominal federal funds rate target would have a larger impact when interest rates are lower. Certainly, there is no reason to expect that the response of investment to changes in the nominal interest rate is linear. At any point in time countless investment projects are available, and as the nominal cost of funds moves lower, the net present value of many more of these projects becomes positive. Accordingly, investment would be unbounded at very low real interest rates, implying that the Fed could conduct a countercyclical policy just as actively and effectively when interest rates were low, even if the nominal federal funds rate target was near zero.

Zero Inflation Is Not Too Low

To summarize, it seems to me that neither the arguments about wage stickiness nor those concerning the zero bound for nominal

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interest rates make a convincing case that monetary policy should aim for a positive rate of inflation. Instead, I believe the logic, and the evidence, both suggest that the appropriate goal for monetary policy should be price stability, that is, a long-run inflation rate of approximately zero.

Today we are enjoying the benefits of a low and comparatively stable rate of inflation. In our present state, we should not forget the high costs of inflation. Inflation makes planning difficult for individuals and firms, it interferes with the operation of markets, and it interacts insidiously with the tax code to discourage saving and investment. Moreover, inflation's effects are felt most acutely by members of society who are economically the most vulnerable. In arguing for a positive rate of inflation, therefore, the burden of proof should rest with those who contend that our economy would perform better with inflation than without it. Inflation proponents also should explain how a moderate rate of inflation could be maintained without inching ever higher. In my view, the case for positive inflation has not been proved.

A central bank's single most important job is preserving the value of the nation's money. Monetary policy has succeeded if the public can reasonably trust that a dollar will buy tomorrow what it will buy today. At this point, inflation will have ceased to be a hindrance to the smooth functioning of our market economy. I cannot promise that price stability will mean an end to the business cycle, to unemployment, or to occasional financial distress. Indeed, I am willing to bet that a few years from now we will look back on 1998 and conclude that the stability of the inflation environment was important to containing the financial-market upset that started in August.

We should not be seduced by arguments that a little inflation is a good thing. Look at the record: Over the past 50 years, our economy has performed better when inflation was low than when it was high. There simply is no compelling evidence that we could foster sustained economic growth by pursuing an inflationary monetary policy. The evidence points in the other direction. Thus, I am confident that our economy's long-run performance would be enhanced by a monetary policy that aims at, achieves, and maintains a zero rate of inflation.

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BOOK REVIEWS

Hayek: Economist and Social Philosopher
Stephen F. Frowen, ed.
New York: St. Martin's Press, 1997, 324 pp.

This book includes the contributions, papers, and comments to a "Memorial Conference on the occasion of the first anniversary of the death of Friedrich August Hayek," held at the University College London from April 28 to 30, 1993. As the editor notes, the volume is meant to "provide a critical assessment of the contributions made by Hayek in fields as diverse as economics, psychology, political philosophy, the philosophy of law and the history of ideas" (p. xxi). Even though the volume does not quite meet the ambitious goal of covering the broad range of Hayekian ideas, it includes contributions on a variety of topics, with a concentration on methodological themes and on Hayekian economic thought.

In a short chapter on "Hayek, Marx and Keynes," Meghnad Desai seeks to support the claim "that there are many parallels" between the three noted authors, a claim that I found and find equally implausible before and after reading the chapter. Some of Desai's observations are clearly perceptive and worthy of further exploration, such as, for instance, the remark that, in his portrayal of the market order, Hayek "veered between leaving the system alone and searching for frameworks of rules that would somehow ensure the Darwinian longevity of the system." But his principal message is no less obscure than his conclusion: "If we are to understand capitalism . . . it is to Hayek and Marx that we shall look. It is to Keynes that we shall look if capitalism is ever to fulfil the promise of being a liberal free system" (p. 6).

Under the title "The Connectionist Mind: A Study of Hayekian Psychology," Barry Smith discusses the parallels between Hayek's theory of knowledge and the mind and the connectionist paradigm in modern cognitive science. Smith notes that Hayek developed—in particular, in "The Sensory Order" (1952)—a theory that, like connectionist approaches, conceives the operation of the mind by analogy "with the massively parallel processing of electrical impulses by the billions of nerves distributed through the human brain, nerves bound together in

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networks that are subject to a constant and subtle forming and reforming of connections" (p. 10). Smith points to the common thrust that unites Hayek's theory of the mind and the "sensory order" with his theory of the market order. Both the mind and the market are described by Hayek as spontaneous orders, and both are explained as "products of thousands of years of evolution," as the result of "a massive number of trials and errors" (p. 24). While recognizing the important insights that the Hayekian-connectionist approach provides, Smith sees certain shortcomings that, in his view, limit its suitability for providing a consistent theoretical foundation for Hayek's social theory. According to Smith, the approach has "no way of dealing with deliberate, conscious thinking" and cannot provide an account of the "connection between reason, choice and action" (p. 22). Although he does not give us a detailed argument supporting his claim, and I would be inclined to doubt it, he certainly raises an issue that is worth pursuing.

In his contribution on "Constitutional Ignorance, Spontaneous Order and Rule-Orientation: Hayekian Paradigms from a Policy Perspective," Manfred Streit argues that the "knowledge problem" is the central theme that unites (and gives coherence to) the various parts of Hayek's work: his epistemology, his theory of the market order, his views on the function and evolution of rules and institutions, and his outlook on issues of economic policy. Concentrating on the latter, Streit discusses the implications of the Hayekian insight into the relation between our "constitutional ignorance" and the need for relying on rules in our efforts in problem-solving ("that, to make the best use of what knowledge we have, we must adhere to rules") for such areas as competition policy, industrial policy, and the problems of "transition from plan to market" faced by post-communist countries. On the latter theme, Streit voices a somewhat skeptical view of the transition societies' ability to reactivate or create the formal and informal rules and institutions needed for a market economy to work. Unfortunately, actual developments have largely confirmed his skepticism. In his comment on Streit, Norbert Kloten takes up the issue of the relation between Hayek's approach to economic policy and the "Ordnungspolitik" approach of the "Freiburg School," founded by Walter Eucken and Franz Böhm. He criticizes Streit for underrating the differences between the two approaches, and argues that the Freiburg emphasis on human design in economic constitutions is "basically incompatible" with the Hayekian emphasis on spontaneous evolution. I do not agree with Kloten's incompatibility thesis. Nor do I feel much sympathy when Kloten, who for many years in Germany has played a prominent role in economic advisory councils, blames a Hayekian evolutionary approach for leaving "practically no room for economic advisors" (p. 60). Yet, I would readily acknowledge that, in order to make sense, the approach must recognize the proper role of deliberate institutional framing. Kloten no doubt is right in emphasizing that this is especially true with regard to the problems faced by transition countries. As he notes, notwithstanding

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the working of evolutionary forces, "transition has to be shaped by political decisions and measures" (p. 61).

The essay "Hayek and the Limitations of Knowledge: Philosophical Aspects," by Stephen Parsons also takes up Hayek's "limited knowledge" thesis as a "unifying theme" of his work. Parsons examines what he considers to be "inconsistencies" in Hayek's arguments on subjectivism and methodological individualism. The cue for clarifying the nature of Hayek's methodological arguments is, according to Parsons, to be found in their "strong affinities with Kantian-inspired systems of thought" (p. 64). To explore those affinities, Parsons devotes his chapter to a "comparison between Hayek and Rickert, a leading neo-Kantian philosopher" (p. 64). Parsons is certainly right in pointing out that ambiguities and inconsistencies may be found in Hayek's work. Yet, in his eagerness to make his case, he overrates the Kantian flavor of Hayek's work and grossly overstates the significance of whatever ambiguities and inconsistencies are there.

In "A Note on Hayek's Analysis of Scientism," Karl Milford examines Hayek's critique of "scientism" as, first, a critique of the misuse of the methods of the natural sciences in the social sciences and, second, a critique of historicism. Much of the 'historicism part' of Milford's chapter focuses on Wilhelm Roscher, the initiator of the German historical school in economics.

Tony Lawson takes his chapter on "Development in Hayek's Social Theorising" as an opportunity to write about a favorite theme of his, "transcendental realism," a methodological approach advanced by Roy Bhaskar. The central theme of Lawson's contribution is that Hayek's early critique of the "scientism of mainstream economics" was inadequate, and that it was only in his later work that he eventually advanced methodologically to a position "consistent with that recently elaborated as transcendental realism" (p. 136). Beginning with a discussion of Hayek's "Scientism and the Study of Society," published in the early 1940s, Lawson traces the development of Hayek's methodological views from only a "partial break with the errors of positivism" to "a more sustainable account of social theorizing" compatible with "transcendental realism," a position that, according to Lawson, began to emerge only much later in Hayek's work. While there are, to be sure, numerous interesting thoughts and stimulating arguments to be found in this paper, it is not entirely clear what important purposes are served by the kind of "historicizing" or "periodizing" approach that Lawson takes, nor is it obvious why "transcendental realism" deserves to be promoted to being the universal yardstick against which the development and achievements of Hayek's theoretical work are to be measured.

The "periodizing" flavor of Lawson's essay permeates even more Steve Fleetwood's article on "Hayek III: The Necessity of Social Rules of Conduct." In addition to the distinction, introduced by Terence Hutchison, between Hayek I (pre-1936) and Hayek II, Fleetwood maintains

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that one ought to draw a further distinction between Hayek II and Hayek III, the critical juncture being the publication of *The Constitution of Liberty* in 1960. The "basis for this sea change," Fleetwood asserts, "lies in Hayek's recognition of the necessity of agents following social rules of conduct" (p. 155). I am very much in agreement with Fleetwood's *systematic* argument that in Hayek's account of the nature of the market what he has to say about the role of rules in coordinating human interaction is an important and essential complement to what he says about the price mechanism as a "telecommunication system." And there are a lot of interesting thoughts that Fleetwood puts forward on "the interaction between the network of social rules of conduct and the network of prices that constitute the telecom system" (p. 174). Much less appealing is his obsession with periodizing Hayek's work to prove that "prior to 1960 Hayek has no understanding of real social structures" (p. 160), and that, supposedly, only "after 1960, Hayek has a clear understanding that rules are the embodiment of society's collected wisdom" (p. 170). He assures us that "it is important to understand that prior to the 1960s Hayek's understanding of tacit knowledge is at best nugatory" (p. 164). I do not think that, as far as Hayek's understanding is concerned, that is actually correct, nor can I see why, if it were true, it would be of any real importance.

In "Hayek's Suggestion for Currency Competition: A Central Banker's View," Otmar Issing takes a critical look at Hayek's proposal for the *Denationalisation of Money*. While being in general agreement with Hayek's views on the virtues of competition, Issing advances two key arguments against the transition to a Hayekian system of "comprehensive, private currency competition," namely, first, that "we know very little about the outcome of such a revolution," and, second, that "we can have a relatively high level of confidence in the national paper money standard with an independent central bank" (p. 188). The second argument may hardly be surprising coming from a member of the Board of the Deutsche Bundesbank, but what certainly deserves to be discussed is Issing's warning that it would "be presumptuous to claim that one knows how currency competition will actually develop in practice" (p. 192).

Hayek's monetary economics is also the subject of Hansjörg Klausinger's article "From Neutral Money to Competing Currencies: Hayek on Monetary Policy." Klausinger examines Hayek's earlier work on monetary economics with the intention "to show that Hayek's later monetary writings are firmly based upon foundations that were already in place in the 1920s and 1930s" (p. 195). In his comment, Roland Vaubel questions Klausinger's continuity argument, claiming instead that Hayek's advocacy of private currency competition and, thus, of "consumer sovereignty in the field of money" marked, in fact, "a radical departure from his earlier advocation of the gold standard" (p. 218), a break that served to bring his views on money more in line with his overall philosophy. As Vaubel puts it: "The Hayek of the gold standard was a young and self-confident

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conservative who—*ex cathedra*—advocated a specific monetary scheme. The Hayek of currency competition was an old and tolerant liberal who wanted to leave the choice to the individual. The mature Hayek recognized his earlier pretence of knowledge and confined himself to suggesting a discovery procedure. By making competition his overarching principle, he finally achieved consistency between his monetary position and his general philosophy" (p. 218).

In his chapter on "Hayek, the Purpose of the Market and American Institutionalism," Mark Perlman provides an informative and perceptive account of the theory of the market contained in Hayek's early essays on "The Trend of Economic Thinking" (1933) and "Economics and Knowledge" (1937). By contrasting Hayek's views with those of the institutionalists—John Maurice Clark's, in particular—Perlman raises an important and interesting issue; namely, whether Hayek's evolutionary account of the market as a purposeless, "natural outgrowth" (p. 232) puts him necessarily in conflict with an instrumentalist outlook as stated by Clark (1949: 52): "An economic system is an instrument. . . . As an instrument, it is to be judged by how well it serves our ends." Perlman does not give us his opinion on this issue, yet it seems obvious to me that a consistent Hayekian theory must accommodate such an instrumentalist perspective. Hayek rightly emphasized, time and again, that the market is not an organization, like a firm or some other corporate entity, set up to "do" specific things and to serve specific purposes. Rather, it is an arena of voluntary exchange and contracting, in which individuals are allowed to pursue their own ends, as long as they stay within the bounds of the "rules of the game of catallaxy." However, this does not mean that existing markets, defined by particular sets of rules and institutions, cannot be meaningfully examined in their instrumental capacity as an arena for voluntary contracting within which individuals can successfully pursue their mutually compatible purposes. Hayek's dictum that social rules can be looked at as "tools" for solving recurrent problems that arise in human interaction and cooperation clearly applies to the rules and institutions of the market no less than to other rules. As "tools" they are instruments that can be examined and compared to potential alternatives, in regard to their relative suitability for solving the problems that they are meant to address. Such an instrumentalist understanding of the market seems to be clearly implied when Hayek speaks of the need for "appropriate rules" that are required to give the spontaneous order of the market its desirable properties (Vanberg 1994: 79).

In "Hayek and Keynes on Capital," G. R. Steele compares Hayek's and Keynes' respective theories of capital, arriving at the conclusion that, by contrast to Hayek, "Keynes' treatment of capital is hopelessly inadequate" (p. 246). Steele is vigorously criticized for this attack on Keynes by his commentators, Jens Hölscher and Victoria Chick. However, I did not find anything in their comments that would repudiate the substance of Steele's specific argument.

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In "Hayek on Trade Unions: Social Philosopher or Propagandist?" Ray Richardson takes a critical look at what Hayek had to say about trade unions. Richardson chooses as the target of his critique a quotation from a 1991 publication (where Hayek states that, in pre-1980 Britain, union power became "the biggest obstacle to raising the living standard of the working class as a whole . . . the prime source of unemployment . . . [and] . . . the main reason for the decline of the British economy in general"). In concentrating his critical assessment on the specific claim that the unions where "the *biggest* obstacle," "the *prime* source," and "the *main* reason" for the said consequences, Richardson assigns himself a fairly easy task, allowing him largely to bypass the question of whether, beyond these particular claims, Hayek has no insights to provide into the role of trade unions. But the same reasons that make Richardson's self-assigned task easy also make his endeavor a rather uninteresting exercise. In his comment, B. C. Roberts puts things in perspective when he notes: "I would myself have qualified the unconditional claims that Hayek made, but if I had to choose between Hayek's general analysis and that of labor economists, . . . I have to say that, on the basis of a lifetime spent studying unions, working with many enterprises as a consultant, as an arbitrator, and also with bodies such as ACAS and the ILO, I believe Hayek's assessment of the general effect of unions is closer to the truth than that made by many of his critics" (p. 276).

The concluding chapter on "Whatever Happened to Hayek?" by E. F. M. Wubben examines the question of why, despite his enthusiastic reception at the London School of Economics in 1931 and his rise to prominence as J. M. Keynes' main competitor, Hayek "was out of the running" by the end of the 1930s. Wubben traces, in an informative account, the development of Hayek's thought during the 1930s, emphasizing the fundamental continuity of Hayek's work over that period. His answer to the question raised is that it was Hayek's genuine interest in fundamental theoretical issues of the evolution and the working of a market economy and "his consequent aversion to satisfying the crying need for prompt and useful policy prescriptions" (p. 282) that put him out of step with the mood prevailing among his contemporaries.

In addition to the papers and comments presented at the 1993 conference, the volume includes a short "Tribute to the Life and Work of Friedrich Hayek" by the late Sir Karl Popper. Apart from recounting the beginnings, in 1935, of their lifelong friendship, Popper points out that he may have had some influence in encouraging Hayek to develop his important contributions to our understanding of "the legal framework of a free society," an understanding that Popper contrasts with Ludwig von Mises' "free market" views. As he puts it: "In a complex society, anything approaching a free market could only exist if it enjoyed the protection of laws, and therefore the state. Thus the term 'free market' should always be placed in inverted commas, since it was always bound, or limited, by a legal framework and made possible only by this framework" (p. 312).

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It should be apparent from the above summary that the volume under review contains a quite heterogeneous collection of contributions, thematically as well as in terms of quality. It is indeed rather difficult to discern any systematic organizing principle that may have guided the selection of articles or may have informed the order in which they are arranged in this volume. Readers who turn to the book expecting to find a balanced coverage of the various fields of inquiry explored by Hayek as an economist and social philosopher may well be disappointed. Yet, there is certainly enough insightful analysis and stimulating arguments in this book to make its reading rewarding.

Viktor Vanberg
Institute for Advanced Study, Berlin

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The Noblest Triumph: Property and Prosperity through the Ages
Tom Bethell
New York: St. Martin's Press, 1998, 378 pp.

Often the only time I find for reading is on airplanes, and so it was on a long flight from New Zealand that I opened Tom Bethell's book. The occasion was all the more fitting because I was returning from a conference on property rights where a government official told the audience that New Zealand had no tradition of property rights, but was founded on the notion of entitlements granted (and taken away) by the government. Boy, could that official learn something from Bethell!

The Noblest Triumph provides a history of property rights and delivers what the subtitle suggests by documenting how property rights are both necessary and sufficient for prosperity. Each section of the book contains two chapters preceded by a brief, but pithy introduction. The first three sections document the philosophical, economic, and legal foundations for property rights. Bethell walks the reader through the economic logic of incentives and the perils of the commons using both evidence and analogies to persuade the nonbeliever.

For those who do not need converting to the property rights paradigm, the book is worth the read simply for its numerous quotes and documentation. If political philosophers or political economists from Adam Smith to Jeremy Bentham, from Karl Marx to Friedrich Engels, or from Ronald Coase to Milton Friedman have said something important about the link between property rights and prosperity, Bethell has read and quoted it. Those of us less willing to do the dirty digging into original sources owe a great thanks to Bethell for his thorough research.

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Having praised Bethell for his synthesis of the property rights literature and for providing evidence on the link between property and prosperity, let me do my duty as a reviewer and highlight the shortcomings of *The Noblest Triumph*. Perhaps because Bethell is a journalist and not an economist, the main weakness of the book is that it lacks keen analytical insights. By presenting private property as an all-or-nothing institution, Bethell ignores the importance of transaction costs and contracting. In Bethell's context, the existence of private property is good; the lack thereof is bad. For example, Bethell uses the example of metering electricity in his apartment complex of a bad property rights regime. But what about the costs and benefits of metering individual consumption? As University of California at Los Angeles economist Harold Demsetz (1967) has pointed out, defining and enforcing property rights only makes economic sense if the benefits exceed the costs. If an apartment house has central heating or cooling, it may be expensive to meter individuals even if the result is overuse of the energy commons.

In *The Noblest Triumph* any commons is a tragedy waiting to be corrected by privatization. Bethell follows economic logic to its extreme, believing that exploiters lurk behind every tree. But abundant examples of well-functioning commons are now well known thanks to people such as Elinor Ostrom (1990) who have examined the details of social organization in small collective groups. Just as family refrigerators usually don't have private shelves for each family member, American Indians did not have private property rights to the fruits of the communal hunt (see Anderson 1995) and Maine lobster fishers do not have private property rights to their fishing grounds (see Acheson 1993), but customs and culture and partial rights control access and restrict overuse of the commons. Reading *The Noblest Triumph*, one would think that each of those cases would result in tragedy.

Or take the case of the modern firm. As Coase (1937) has explained, capitalistic firms are mostly run by command-and-control. From reading Bethell, one would predict that the firm should fall by the wayside in deference to piece-rate contracting between many independent producers. But of course transaction costs matter, making it necessary to trade off the gains from piece-rate contracts with the costs of negotiating those contracts. In a world of positive transaction costs, property rights are not so black or white as Bethell describes them. In short, for the reader familiar with the rich literature on the interface between transaction costs and property rights, portions of *The Noblest Triumph* will be a disappointment.

The Noblest Triumph also falls short with its specific applications. For example, Bethell's chapter on the environment does not even do a good job of surveying the abundant example of free market environmentalism at work. Countering the idea that market failure runs rampant over the environment are hundreds of examples of property rights encouraging stewardship of natural resources. Bethell does present the well-known

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case of the Audubon Society's Rainey Wildlife Sanctuary and the elephant programs in southern Africa. But the elephant example depends on communal rights that he generally shuns throughout the book. There are better data in support of Bethell's property rights thesis such as the fact that deforestation rates, pollution levels, and other environmental indicators are lower in countries with the rule of law and property rights. Around the world, envirocapitalists are using property rights to enhance stream flows, reduce overfishing, restore wildlife habitat, and save endangered species. Bethell could have added credibility to his argument if he had used these examples.

These criticisms notwithstanding, *The Noblest Triumph* is must reading for all serious property rights scholars. Though the book lacks analytical sophistication, Bethell's careful survey of the historical antecedents and contemporary fruits of private property ends with the hope that "governing classes come to see the domestic and institutional roots of their own difficulties" (p. 341). If the government officials at the conference referred to at the outset of this review do not get Bethell's important message, then New Zealand's economic revolution begun in the late 1980s will be short lived. Bethell is optimistic that "the hundred-year experiment in socialism is over" (p. 341). If it is not, it will be because people do not understand the essential link between secure property rights, what Bentham called "the noblest triumph of humanity over itself," and prosperity.

Terry L. Anderson
Political Economy Research Center

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The Story of American Freedom
Eric Foner
New York: W.W. Norton, 1998, 422 pp.

In the introduction to his new book *The Story of American Freedom*, Eric Foner, professor of history at Columbia University and past president of the Organization of American Historians, writes: "No idea is more

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fundamental to Americans' sense of themselves as individuals and as a nation than freedom. The central term in our political vocabulary, 'freedom'—or 'liberty,' with which it is almost always used interchangeably—is deeply embedded in the documentary record of our history and the language of everyday life."

Indeed, who can doubt this? For evidence, just look to today's public policy debates. No matter the issue, both sides claim to be promoting freedom. Opponents of the Americans with Disabilities Act, for example, said the bill made a mockery of freedom of contract and association, while proponents said it enhanced the freedom of the wheelchair-bound, among others. Likewise, skeptics of the minimum wage say it violates the right of employers and employees to come to a mutually agreeable bargain without third-party intervention. But fans of such legislation say it enhances the freedom of laborers, by guaranteeing them a sum of money sufficient for basic necessities as well as, perhaps, some leisure.

Foner's goal is to chronicle how these different understandings of freedom came to pass—how, in other words, the term "freedom" has evolved in America since the colonial period. "Rather than discussing freedom in the abstract," he writes, "I attempt to locate it in particular historical circumstances, showing how at different periods of American history different ideas of freedom have been conceived and implemented, and how the clash between dominant and dissenting views has constantly reshaped the idea's meaning."

There can be little question, Foner argues, that the American colonists' notion of freedom was strongly influenced by their study of British history and by their own identification as British subjects. "Power and liberty were widely believed to be natural antagonists, and in their balanced constitution and the principle that no man, even the king, is above the law, Britons claimed to have devised the best means of preventing political absolutism," Foner writes.

These beliefs, combined with the idea of self-ownership, laid the intellectual groundwork for the revolution. "By the end of the revolutionary era, the concept of property had expanded to include rights and liberties as well as physical possessions," Foner notes. For instance, at the Constitutional Convention of 1787, Madison declared: "A man has property in his opinions and the free communication of them, he has property in . . . the safety and liberty of his person."

This understanding of freedom—the belief that freedom principally means the right not to be aggressed upon—led many, but not all, early American leaders to embrace the minimal state. Foner argues that remained the case until the mid-19th century, when a growing number of people became dismayed with what they saw as ever-rising income inequality. For freedom to be enjoyed by all, it was argued, a more egalitarian distribution of resources must be ensured.

What resulted was the rise of Owenite utopian communities—which aimed to fundamentally alter the relationship between the worker and

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the employer—and less ambitious reform movements that championed state provision of social services and regulation of the workplace. The latter, Foner argues, were the precursors of the Progressive movement.

Foner's discussion of the late 19th and early 20th centuries is one of the most useful sections of the book. He does two things remarkably well. First, he debunks the notion—far too popular among some classical liberals—that the rise of the modern welfare-regulatory state can be traced back to the New Deal and no further. Second, he recounts the highly technocratic and often authoritarian views of the early Progressives, and shows how World War I and the Red Scare led them to rethink their unstinting faith in the goodness of the state.

Near the turn of the century, social scientists and public intellectuals such as Herbert Croly, John Dewey, and William Willoughby claimed that freedom had to be redefined. It was no longer useful to think in terms of "freedom from." Instead, society needed to frame the debate in terms of "freedom to."

Foner writes: " 'Effective freedom,' wrote John Dewey, who pondered the question from the 1890s until his death in 1952, was far different from the 'highly formal and limited concept of liberty' as a preexisting possession of autonomous individuals that needed to be protected from outside restraint. It meant 'effective power to do specific things,' and as such was a function of 'the *distribution* of powers that exists at a given time.' " Similarly, Willoughby proclaimed that Progressivism "looks to state action as the . . . only practicable means now in sight of giving to the individual, all individuals, not merely a small economically strong class, real freedom."

At the federal level, these activists pushed for the creation of the Federal Trade Commission and the passage of the Pure Food and Drug Act, among other things. And they enjoyed even more legislative success at the state and municipal levels. Proof that Progressivism was becoming the dominant ideology of the period came in the 1912 election, when the four leading presidential contenders all called for a more activist state. The winner, of course, was Woodrow Wilson, who, foreshadowing FDR's Four Freedoms speech, argued that "freedom today is something more than being let alone. The program of a government of freedom must in these days be positive, not negative merely."

Who was to guide this new beefed-up government? The intellectual class, which would be culled from the country's leading universities and journals of opinion. In short, people like Croly, Dewey, and Willoughby. World War I excited many of the members of the up-and-coming managerial elite, because, as Foner writes, the war "created a national state with unprecedented powers and administrative capacities." This giddiness faded, however, when many left-wing activists were rounded up after the war for their "subversive" activities. This was the moment, Foner perceptively notes, when Progressivism slowly morphed into modern liberalism. Up to this point, large parts of the left were preoccupied with

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(planned) efficiency and order to the exclusion of all else. These concerns were now modified and combined with a fervent, if inconsistent, defense of free expression and civil liberties generally.

Chapter 8, "The Birth of Civil Liberties," is also highly valuable, for Foner points out that until the 1920s and 1930s, the idea of what constituted civil liberties was rather narrow. Political speech and the right to worship as one wished were generally defended by the courts, albeit with some notable exceptions. But when it came to other matters, particularly sexual issues, things were very different. Emma Goldman was regularly jailed for speaking about birth control, and Moses Harman, editor of the individualist newspaper *Lucifer, the Light Bearer*, was imprisoned for publishing articles questioning the morality and legality of rape within marriage. Today, such events are unthinkable.

These sections of the book, in particular, show us that American history cannot be neatly summed up. It has been characterized by neither a constant upward march toward freedom and liberty, as some would have us believe, nor a slow and steady betrayal of the libertarian principles of the revolution, as others often claim. Instead, there have been some advances and some (probably many more) declines.

The final five chapters of *The Story of American Freedom* discuss the New Deal, World War II, the Cold War, the 1960s, and "conservative freedom," that is, the 1980s and 1990s. Foner's treatment of these topics is knowledgeable. His analysis of the New Left—and its rapidly changing agenda, from decentralism and individualism to conventional state socialism—is especially enlightening. His analysis is far from even-handed, though. He engages in shallow hyperbole, for instance, when he says that in the 1980s "Great Society antipoverty programs were gutted." (Though, to be fair, he also notes that "core elements of the welfare state such as Social Security, Medicare, and Medicaid remained intact.") And one can question his claim that in the 1970s New Right "Christian conservatives (many of whose leaders proved highly adept at using the mass media to raise funds and disseminate their ideas) fully embraced the free market economics of libertarian conservatives."

Many market liberals, I fear, will be turned off by this book before even opening the cover. Foner, it is true, is no fan of the classical-liberal legal order. He equates the "market society" with "greed, selfishness, and indifference to the welfare of others," arguing that capitalism provides "hardly the foundation of a moral community." What's more, Foner seems convinced that private spending on campaigns is the paramount threat to political freedom in the United States today, and that all would be solved if the "public"—that is, government—just financed political activity. Such sentiments unquestionably color many of his interpretations, and probably account for the omission of some noteworthy events and people. Nevertheless, Foner shows a tremendous power for integrating ideas into a coherent narrative, and he should be applauded for taking on a task as

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sweeping and important as telling "the story of American freedom" at a time when many historians are engaging in increasingly arcane research projects.

Aaron Steelman
Investor's Business Daily

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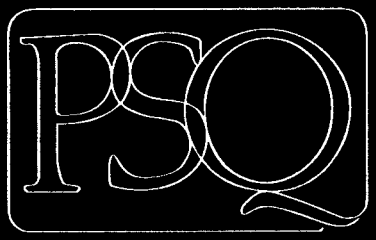

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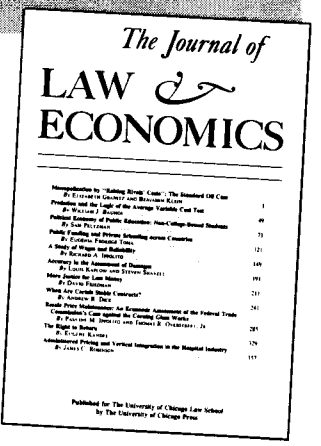

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—Mao Yushi

"China Rediscovers Hayek," *Asian Wall Street Journal*, 12 June 1998.

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